



\_the international tax letter  
Autumn-Winter 2006  
Issue 2

Ts Tax Advisors SA

## \_the international tax letter

EU

### state aid: Commission demands repeal of Luxembourg's preferential tax regime for financial holdings



The European Commission has decided that the preferential tax regime in favour of Luxembourg's Exempt, Milliardaire and Financial Holdings of 1929 violates EC Treaty state aid rules (Article 87). The scheme is granted under a Luxembourg law from 1929, predating the EC Treaty, and therefore constituting existing aid.

Following an in-depth investigation opened in February and a preliminary

four-year review, the Commission has concluded that the scheme grants unjustified tax advantages to providers of certain financial services who set up holding structures in Luxembourg. It distorts competition and trade by altering the level playing field between financial undertakings and induces them to create dedicated structures in Luxembourg to reduce their current tax liabilities.

Modifications introduced by a law of 21 June 2005 narrowed the scope of the

scheme but the regime still constitutes state aid as the tax advantages remain unchanged. The Commission decision requires the scheme to be repealed by the end of 2006, while its effects for the existing holdings must be definitively eliminated by the end of 2010. As the scheme is existing aid, the Commission's decision is only for the future and the beneficiaries need not repay aid received until its final elimination.

Dott. Uberto Meraviglia Mantegazza

### PROTOCOL TO TREATY BETWEEN LUXEMBOURG AND FRANCE

#### immovable property and business profit provisions amended

On 2 August 2006, the Luxembourg tax administration announced that Luxembourg and France signed in July 2006 a second protocol to the tax treaty on income and capital of 1 April 1958.

The objective of the protocol is to solve the current issue of double non-taxation in the situation where a Luxembourg company owns French Real Estate without having a PE in France. The French Supreme Administration Court highlighted this "double non-taxation issue" on 18 March 1994. The Court ruled that income derived from French real estate owned by a Luxembourg company must be characterized as business income, which would be taxable in France only if attributable to a PE there. At the same time, the Administrative Court of Luxembourg held in its decision of 23 April 2002 (*La*

*Costa* case), that income derived by Luxembourg companies from French real estate, being characterized as income from immovable property, is taxable only in the situs country and exempt from tax in Luxembourg.

Art. 1 of the protocol contains provisions to broaden the scope of Art. 3 (Immovable property) of the treaty. It divides Art. 3 into three paragraphs, by adding two new paragraphs and rescheduling the current provisions into Para. 1, as follows

- Para. 1 will also apply to income arising from the exploitation and sale of real estate owned by an enterprise (new Para. 2).

- The provisions of Paras. 1 and 2 also apply to companies which, regardless of their legal form, do not have a legal

personality separate from that of their members (new Para. 3).

Arts. 2 and 3 of the protocol add to Arts. 4 and 15 a provision similar to Art. 7(7) of the OECD Model, whereby items of income dealt with under other provisions of the treaty are not affected by provisions of Arts. 4 and 15 of the treaty. As a result, income from immovable property will be classified as income from immovable property taxable in the situs country, and no longer as business income the taxation of which requires the presence of a PE.

Art. 4 of the protocol contains formal provisions, including the provision that the protocol will be applicable to profits realized in the year following the year in which the protocol enters into force.

Dott. Uberto Meraviglia Mantegazza



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### CYPRUS

## Cyprus holding companies

Cyprus has always been an ideal location for holding companies, and in light of the 2003 tax reform, the island's attractiveness as a holding company location has been highly upgraded in comparison to other financial centers around the world. Offering the lowest tax rate in the EU, complying with the EU requirements as well as OECD requirements against harmful tax practice, have made Cyprus an ideal IFC for both inbound and outbound EU investors.

Cyprus is most commonly used as an **intermediate holding company** jurisdiction and is of particular interest in the following circumstances:

- For groups international or domestic investing outside Cyprus, aiming at dividend income streams. Such

dividend in most cases will be tax exempt in Cyprus

- To hold subsidiaries that have scope for significant capital appreciation and that may be spun off or sold in the future. Such disposals are not taxable in Cyprus

- To benefit from the favourable withholding tax provisions of the Cypriot double tax treaties network and the EU parent-subsidiary directive and the other directives

- Where a jurisdiction is required that does not have controlled foreign company legislation

- Where it may be important to achieve a tax free unwind of the holding company at some stage in the future



- To avail of the easy exit strategy under Cypriot law which allows payment of dividend, interest and royalties (in most cases) without payment of withholding tax

- Appropriate for any fund or investment vehicle, as there is no tax on transactions in securities as defined, even if this is the trading activity of the entity.

### CORPORATION TAX:

**Taxation of Trading Income:** Trading income is taxed at the rate of 10%

**Taxation of Dividend Income:** Dividends and other profit distributions received by a Cypriot tax resident company from another Cypriot tax resident company are exempt from Corporation Tax.

Dividends and other profit distributions received by a Cypriot tax resident company from a foreign company are exempt from Corporation Tax. Such income is also exempt from *Special Contribution for Defence* (15%) provided that the company receiving the dividend owns at least 1% of the company paying the dividend.

This exemption does not apply only if:

- more than 50% of the paying company's activities result directly or indirectly in investment income, and
- the foreign tax is significantly lower than the tax rate payable in Cyprus.

**Repatriation of Dividends from Cyprus:** Cyprus does not impose any withholding tax on dividends and other profit distributions paid by a Cypriot company to non tax resident shareholders, including both individuals and corporations.

**Tax Exemption on Disposal of Shares:** The profit arising on the disposal by a Cypriot tax resident company of shares in a company is exempt from any tax in Cyprus, provided the shares disposed qualify as "titles" under the provisions of the Cypriot Tax Legislation. "Titles" are defined as Shares, Bonds, Debentures, Founder and other titles of companies or legal persons incorporated in Cyprus or abroad and rights thereon.

**Controlled Foreign Corporation ("CFC") Legislation:** Cyprus does not have controlled foreign corporation legislation. As a result, no income is imputed to a Cypriot parent even if the income arises in a tax haven or out of passive activities.

**Thin Capitalisation:** Cypriot tax legislation does not contain thin capitalization provisions.

**OTHER TAXES:** There are no other significant taxes to be taken into consideration for holding companies in Cyprus.

**Cessation of Operations:** A Cypriot holding company held by non-resident shareholders can cease operations in Cyprus and distribute assets to its shareholders in any form (dividends, proceeds on liquidation, etc) without any tax cost to the shareholders. If the Cypriot holding company owns immovable property in Cyprus then its disposal at the time of ceasing operations can result in Capital Gains tax.

#### TS TAX ADVISORS S.A.

Prof. Dott. Stefano Graidi  
CH - 6901 LUGANO, PALAZZO GARGANTINI  
RIVA ALBERTOLLI 1  
Tel: +41 91 9125050  
Fax: +41 91 9125060  
[stefano.graidi@ts-tax.net](mailto:stefano.graidi@ts-tax.net)  
[www.ts-taxadvisors.ch](http://www.ts-taxadvisors.ch)

#### ORIENTA Sagl

Prof. Dott. Gilberto Gelosa  
Nathalie Facon  
Tel: +39 02 863 31 11  
Fax: +39 02 890 135 55  
[g.gelosa@interconsulting.mi.it](mailto:g.gelosa@interconsulting.mi.it)  
[n.facon@pragma-eu.com](mailto:n.facon@pragma-eu.com)  
[www.pragma-eu.com](http://www.pragma-eu.com)

#### PRAGMA

Prof. Dott. Gilberto Gelosa  
Nathalie Facon  
Tel: +33 (0) 3 20 55 62 55  
Fax: +33 (0) 3 20 55 62 60  
[g.gelosa@interconsulting.mi.it](mailto:g.gelosa@interconsulting.mi.it)  
[n.facon@pragma-eu.com](mailto:n.facon@pragma-eu.com)  
[www.pragma-eu.com](http://www.pragma-eu.com)



Dott. Uberto Meraviglia Mantegazza