Effectiveness of the Participation Exemption

Seminar I

Wednesday, 2 September 2015

Structure

- **Core Issues**
  - Scope and Goals of Participation Exemption Regimes
  - Exemption versus Indirect Credit
- **Limits and Exceptions to Participation Exemption Regimes**
  - Limits to Cost Deduction
  - Limits to Depreciation Deductions
  - Timing Issues
  - Direct Tax Credit Issues
  - Loss Situations
  - Switch-Over Clauses and Other Anti-Abuse Provisions
  - Hybrid Financial Instruments and Double Non-Taxation
- **Conclusions**

Your Panel

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  - Gauthier Blanluet
  - Eric Kemmeren
  - Ruth Mason
  - Toshio Miyatake
- **Secretary**
  - Florian Regli
- **Chair**
  - Georg Kofler

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Partner, Sullivan & Cromwell; Professor of Business Tax Law, University of Paris II (France)

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Professor of International Taxation, Tilburg University (Netherlands); Of Counsel, Ernst & Young Tax Advisers; Deputy Justice of the Arnhem Court of Appeals (Tax Division)

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Hunton & Williams Professor of Law, University of Virginia School of Law (USA)

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Managing Partner at Adachi Henderson Miyatake & Fujita (Japan)

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Area Tax Director at Roche (Switzerland)

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  - **Georg Kofler**

Professor of Tax Law,
Johannes Kepler University
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Core Issues

Question 1

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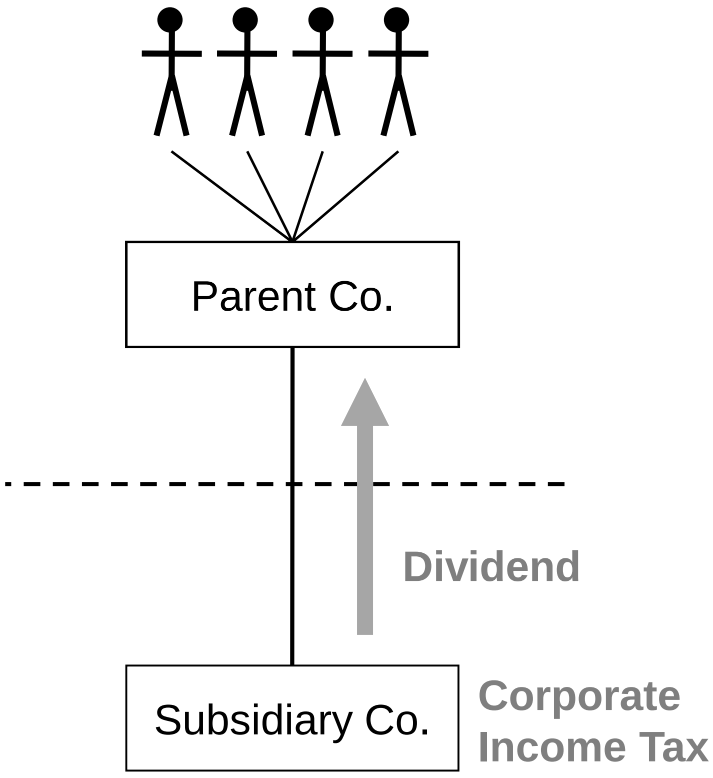
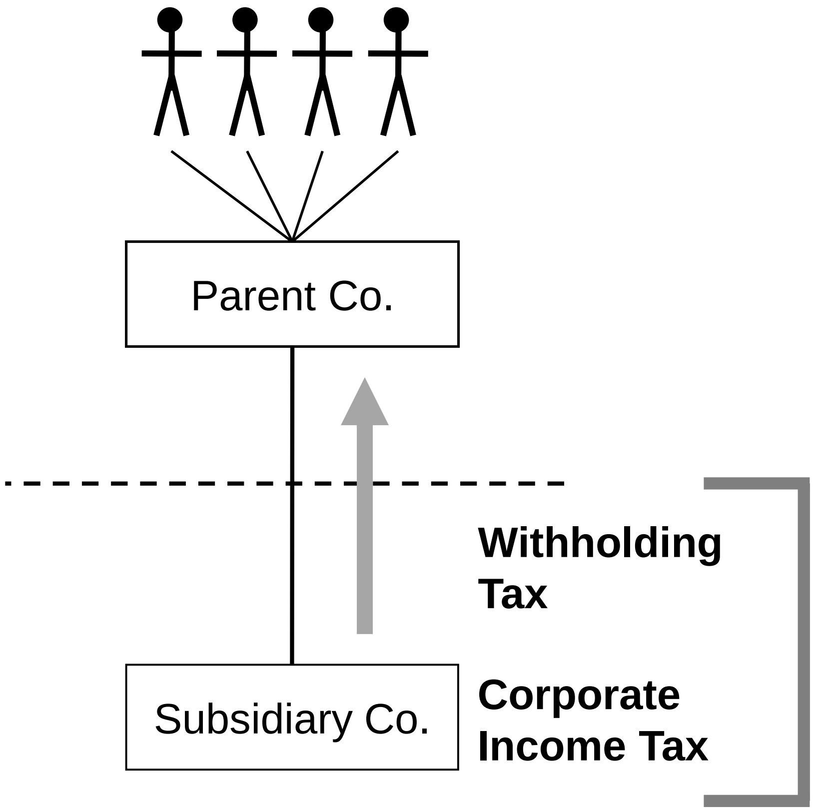
- **Is the Participation Exemption Effective?**

Three Types of Double Taxation

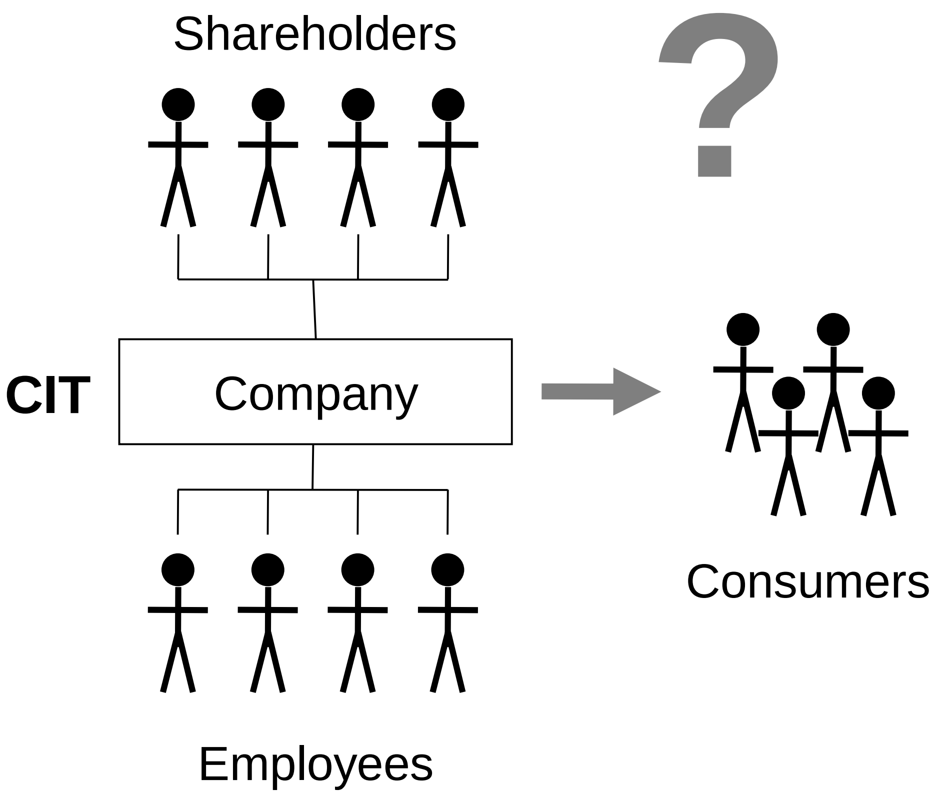


Three Types of Double Taxation



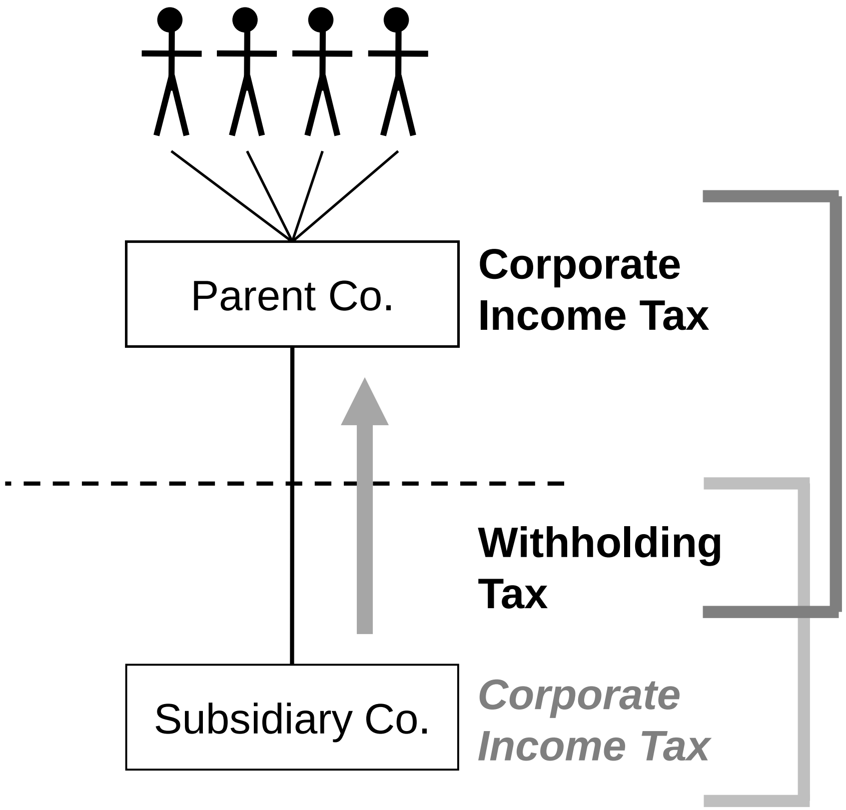
- Domestic Economic Double Taxation
- Withholding Taxation addressed, e.g., by Tax Treaties (Art. 10 OECD-MC), the EU Parent-Subsidiary-Directive (Art. 5), and the EU Fundamental Freedoms

Excursus: Incidence of the Corporate Tax



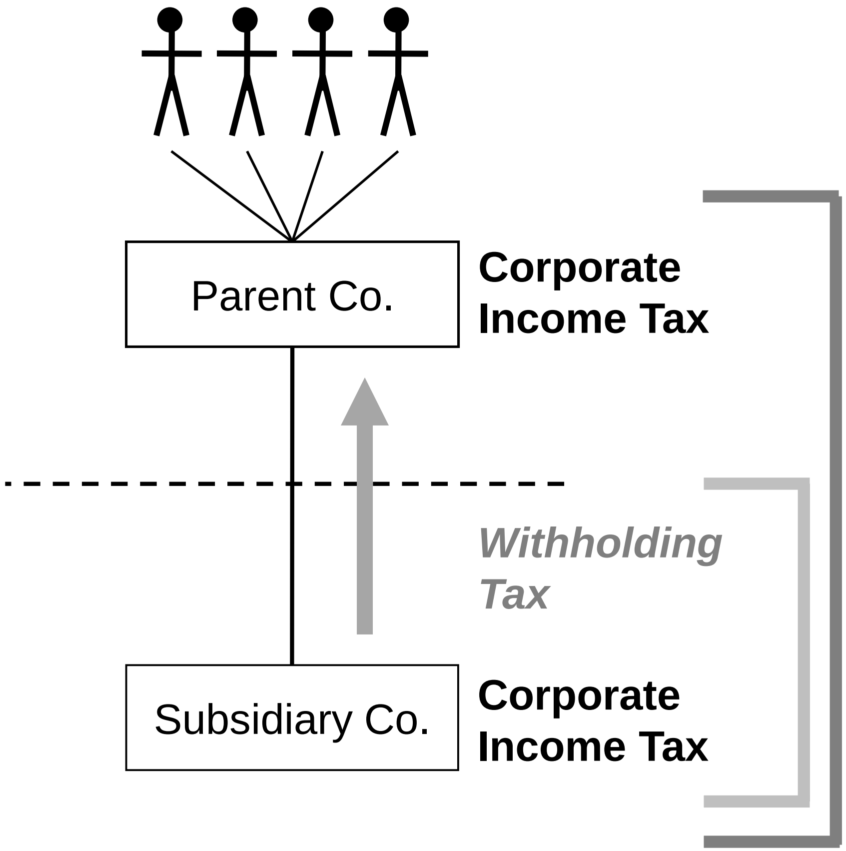
- Implicit assumption (for relief of economic double taxation) that the corporate tax is economically borne by capital/corporate capital and is not shifted to immobile factors (labor, land)
- But: Incidence of the corporate tax?

Three Types of Double Taxation



- Juridical Double Taxation
- Taxation in the recipient's State addressed, e.g., by Tax Treaties (Art. 23 OECD-MC)

Three Types of Double Taxation



- Cross-Border Economic Double Taxation
- Generally not addressed by Tax Treaties (Art. 23 para. 54 OECD MC Comm.), but, e.g., addressed by the EU Parent-Subsidiary-Directive (Art. 4)
- Possible Regimes
  - Participation Exemption
  - Indirect Tax Credit

Purposes and Scope

- **Purposes**
  - **Elimination of Economic Double Taxation**
  - International Competitiveness
  - Repatriation of Profits
  - Stimulation of the Economy
- **Scope**
  - Profit Distributions
  - Capital Gains
  - Other Items
- **Prerequisites and Limits**
- **Domestic and Cross-Border Situations**

- Basic considerations
  - Removal of double taxation
  - Treatment of foreign branches
- 26 out of 34 OECD Member States employ exemption
- 27 out of 28 EU Member States have chosen the exemption method under the Parent-Subsidiary-Directive

Purposes and Scope

- **Goals**
  - Elimination of Economic Double Taxation
  - **Competitiveness**
  - **Repatriation of Profits**
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- **Domestic and Cross-Border Situations**

- Competitiveness
  - Territoriality versus worldwide taxation
  - "Capital Import Neutrality"
  - International trend
  - Simplification
- Recent moves to exemption in cross-border situations: Australia (1991), Germany (2001), Japan (2009), New Zealand (2009), United Kingdom (2009)
- Response to Trapped Earnings: U.S. Dividend Received Deduction (only 2005)

Purposes and Scope

The proposals set out in this discussion document are intended to:

- improve the competitiveness and attractiveness of the UK as a location for multinational business, while ensuring any new systems or structures that are subsequently introduced cannot be used to undermine the UK tax base; and
- provide equally fair, but different approaches, tailored to the different sizes of companies, reflecting the different circumstances they face.

HM Treasury, Taxation of the foreign profits of companies: a discussion document (June 2007), 10-11.

1.3 It is important that New Zealand's tax system is not out of line with systems in comparable jurisdictions, particularly Australia. Within an increasingly borderless global economy, New Zealand must be able to attract and retain capital, and our businesses must be able to compete effectively in foreign markets.

New Zealand's International Tax Review: a direction for change: a government discussion document (Dec. 2006)

2.25 Moving to a broader exemption system for all dividends from a foreign affiliate, and possibly exempting capital gains arising from the sale of shares of a foreign affiliate, would be consistent with recent international developments. It would also simplify compliance for both taxpayers and the CRA, for example, by reducing or eliminating the need to track exempt and taxable surplus accounts. However, a broader exemption system raises considerations that may require other consequential changes to the Canadian System.

Enhancing Canada's International Tax Advantage A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation (Apr. 2008).

Excursus: Exemption versus Indirect Credit

Normative Framework: "Battle of Neutralities"

Neutrality	Standard	Benchmark	Achieved by
Location of Investment	Capital Export Neutrality (CEN)	Neutrality between domestic and foreign investments producing the same pre-tax rate of return	Immediate Taxation and Full Credit
	National Neutrality (NN)	Preference for domestic investments whenever the pre-tax rate of return exceeds the return on a foreign investment net of foreign taxes	Immediate Taxation and Deduction of Foreign Tax
Savings	Capital Import Neutrality (CIN)	Neutrality between foreign and domestic investors, i.e., equal after-tax rates of return for each investor	Adoption by *all* Countries of the Exemption Method
Identity of Investors	Capital Ownership Neutrality (CON)	Neutrality regarding which corporation owns and exploits assets, i.e., corporations that exploit a given asset most efficiently are willing to pay the most to own that asset	Adoption by *all* Countries of either the Full Credit Method or the Exemption Method
	National Ownership Neutrality (NON)	Encourage residents to make foreign investments that yield a higher after-tax rate of return than domestic investments	Adoption by *all* Countries of the Exemption Method

Question 2

?

- **Is the Participation Exemption a Tax Privilege?**

Purposes and Scope

- **Goals**
  - Elimination of Economic Double Taxation
  - Competitiveness
  - Repatriation of Profits
  - Stimulation of the Economy
- **Scope**
  - **Profit Distributions**
  - Capital Gains
  - Other Items
- **Prerequisites and Limits**
- **Domestic and Cross-Border Situations**

- "Real" distributions ("open" and "constructive")
- "Fictitious" distributions (e.g., under CFC rules, reorganization rules, secondary TP adjustments)
- Timing issues

Purposes and Scope

- **Goals**
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- Similarity between capital gains and profit distributions?
- Art 13 OECD MC, not addressed by the EU Parent-Subsidiary-Directive
- Covered by many domestic participation exemption regimes
- Requires a number of additional rules, e.g., for situations in which a qualifying participation starts or ceases to exist following a reorganization

Purposes and Scope

- **Goals**
  - Elimination of Economic Double Taxation
  - Competitiveness
  - Repatriation of Profits
  - Stimulation of the Economy
- **Scope**
  - Profit Distributions
  - Capital Gains
  - **Other Items**
- **Prerequisites and Limits**
- **Domestic and Cross-Border Situations**

- E.g.,
  - Changes in value of earn-out rights
  - Other price adjustments
  - Currency risk instruments

Question 3

- **Should Participation Exemption Apply to Capital Gains?**

Purposes and Scope

- **Goals**
  - Elimination of Economic Double Taxation
  - Competitiveness
  - Repatriation of Profits
  - Stimulation of the Economy
- **Scope**
  - Profit Distributions
  - Capital Gains
  - Other Items
- **Prerequisites and Limits**
- **Domestic and Cross-Border Situations**

- Typical prerequisites for exemption
  - Minimum ownership requirement
  - Minimum holding period
  - Active business, comparable taxation, DTC or TIEA
  - Anti-Arbitrage/Hybrid instruments provisions
- Typical safeguard-provisions
  - Switch-Over and/or CFC Rules
  - Deductibility of expenses, write-downs

Purposes and Scope

- **Goals**
  - Elimination of Economic Double Taxation
  - Competitiveness
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- **Scope**
  - Profit Distributions
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  - Other Items
- **Prerequisites and Limits**
- **Domestic and Cross-Border Situations**

- Different systems for domestic and cross-border inter-company profit distributions
- Various discrimination-issues under the EU fundamental freedoms
  - Extension of domestic relief systems (e.g., *FII*)
  - "Equality" of exemption and indirect credit (e.g., *Haribo and Salinen*, *FII 2*)
  - Differences in cost deduction rules (e.g., *Bosal Holding*, *Keller*, *Groupe Stéria*)

Domestic and Cross-Border Situations

	Domestic			Cross-Border	
	Exemption	**DRD**	**Imputation**	**Exemption**	**Indirect Credit**
Australia	1936-2001	—	**2002-**	1936-1987, **1991-** (100%)	1987-2004
Austria	1920-1937 (80%), **1938-** (100%)	—	—	**1973-** (100%)	—
France	1920 (100%)	—	—	1929 (100%, 95%)	
Germany	1920-1976 (100%), 2001-2003 (100%), **2004-** (95%)	—	1977-2000	**2001-** (95%)	1972-2000
Japan	**1950-** (100%)	—	—	**2009-** (95%)	1962-2008
Luxembourg	**1940/1968-** (100%)	—	—	1968-1978 (50%), **1979-** (100%)	—
United Kingdom	**1803/1965-** (100%)	—	—	**2009-** (100%)	1920/1945/ 1950-2009
United States	—	1918-1935 (100%), 1936 (90%), 1937-1986 (85%), 1987 (80%), **1988-** (70%, 80%, 100%)	—	—	**1918-**

Limits and Exceptions to Participation Exemption Regimes

Overview

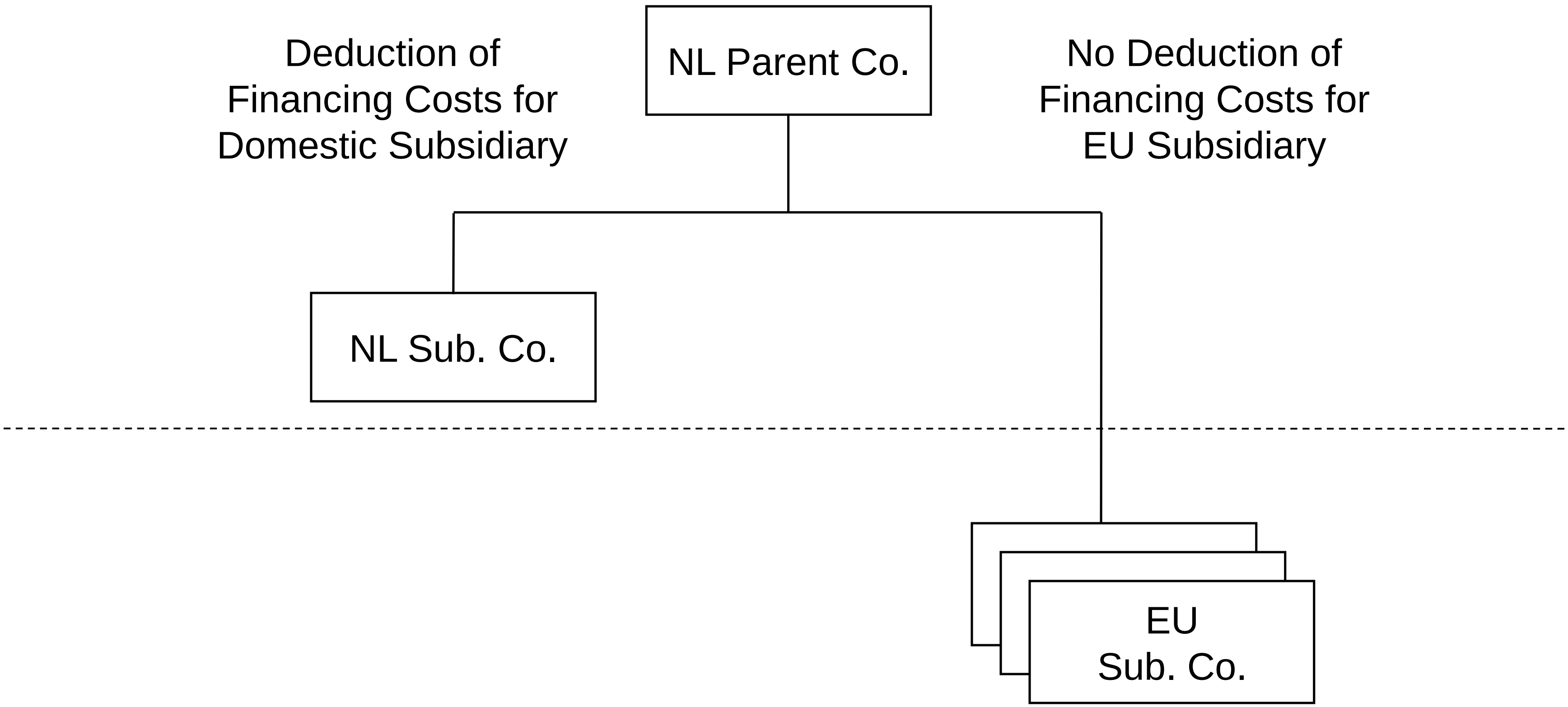
- **Limits to Cost Deduction**
- **Limits to Depreciation Deductions**
- **Timing Issues**
- **Direct Tax Credit Issues**
- **Loss Situations**
- **Switch-Over Clauses and Other Anti-Abuse Provisions**
- **Hybrid Financial Instruments and Double Non-Taxation**

Limits to Cost Deductions

- **Core Issues**
  - Interest on loans to acquire a holding
  - Due diligence costs
  - Currency losses
- **Allocation and Apportionment of Expenses**
- **“Lump-Sum Solutions”**
  - E.g., 5% of the dividend deemed to be nondeductible costs
  - Art. 4(3) of the EU Parent Subsidiary Directive
- **Timing**
  - “Abstract” versus “concrete” approach – “Ballooning”

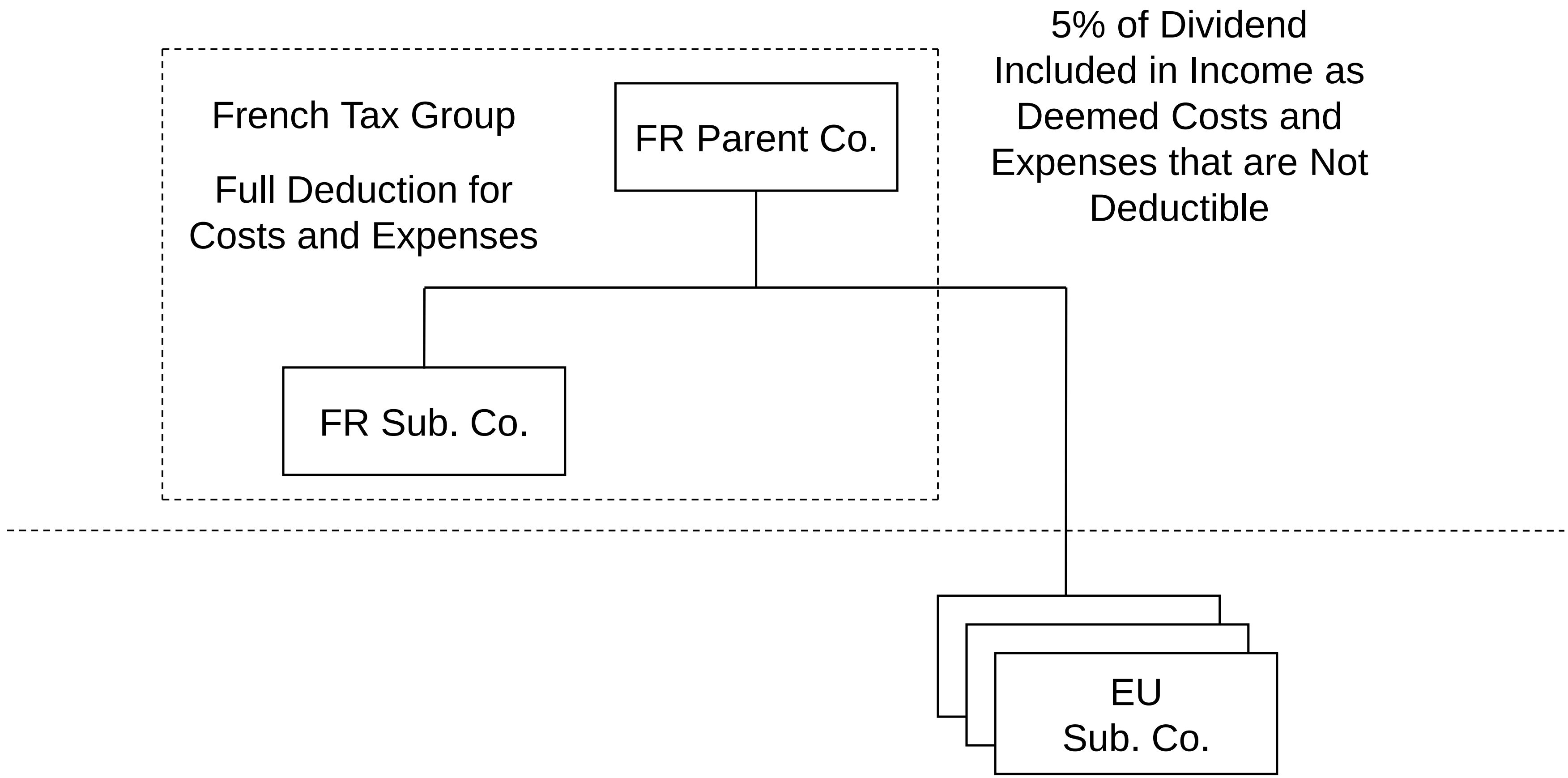
Limits to Cost Deductions

ECJ, 18 September 2003, C-168/01, ***Bosal***, [2003] ECR I-9409



Limits to Cost Deductions

ECJ, 2 September 2015, C-386/14, ***Groupe Steria***



Question 4

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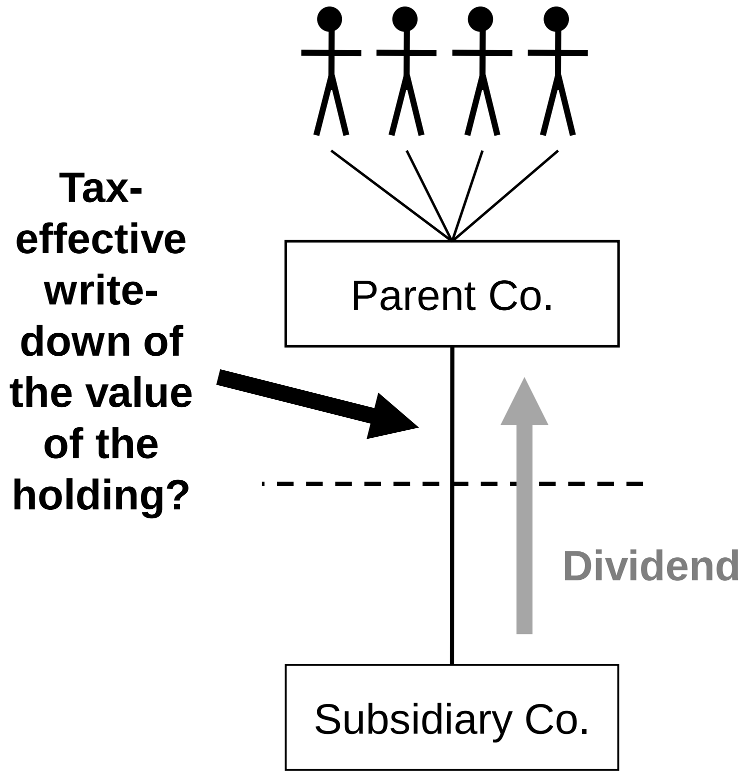
- **Should Expenses be Tax Deductible if the Related Income is Subject to a Participation Exemption?**

Limits to Depreciation Deductions

- General limitations
- Limitations based on the reduction in value caused by distributions (e.g., Art. 4(3) of the EU Parent Subsidiary Directive: "losses resulting from the distribution of the profits of the subsidiary")

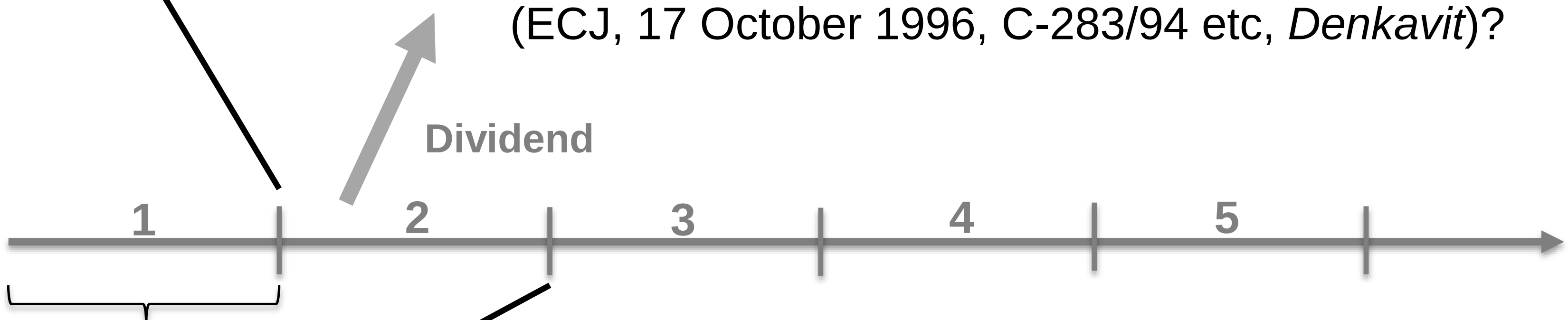


Decrease in value, e.g., because of the distribution

Timing Issues

- Acquisition of a qualifying holding (e.g., 10%)
- Accession of the subsidiary‘s State to the EU
- Change of the legal form of the subsidiary

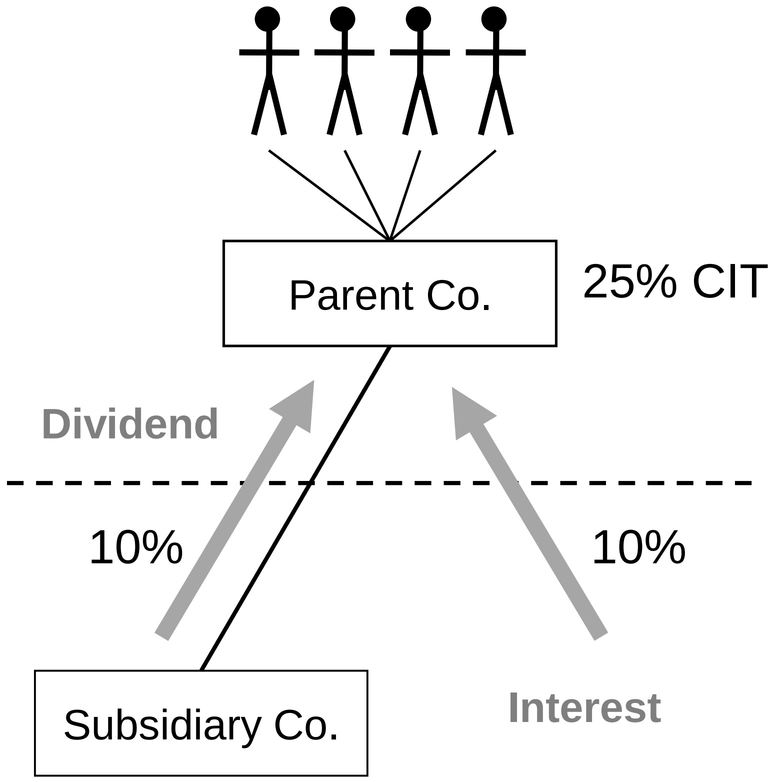
- “Compartmentalization?” Relevance of the date of distribution or of the generation of underlying profits?
- Relevance of holding periods (e.g., 1 year)? What if the holding period is completed after the distribution (ECJ, 17 October 1996, C-283/94 etc, *Denkavit*)?



- Effects of a subsequent
  - increase of a qualifying holding (e.g., from 10% to 15%)?
  - decrease of a holding (e.g., from 10% to 5%)? *Conseil d‘Etat 15 December 2014 SA Technicolor.*

Direct Tax Credit Issues

- Operation of the direct tax credit limitation for withholding taxes related to tax-exempt dividends?
- *Per-item*-limitation versus *per-country*-limitation?

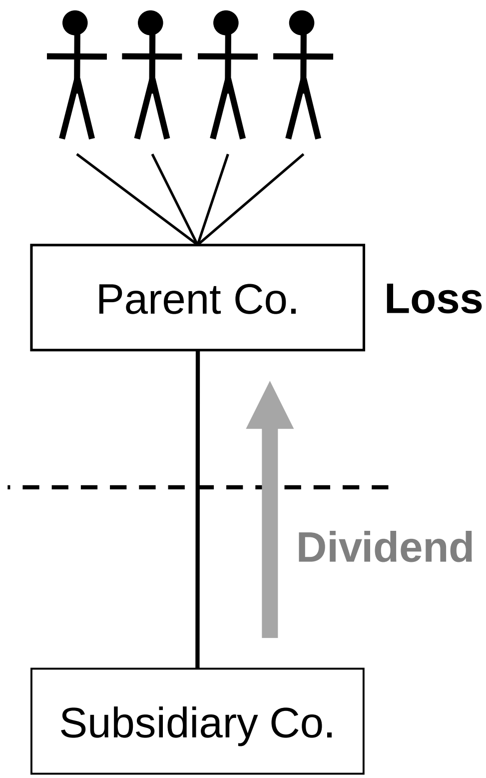


Loss Situations

- Effect of Exempt Dividends on the Parent‘s Losses?
- Treatment of Losses in Case of a Liquidation of a Participation? – “Final Loss” Exception under *Marks & Spencer* (C-446/03) and *Commission vs. UK* (C-172/13) in the EU?
- Treatment of Currency Losses? – Justification of “Symmetrical” Approaches in the EU (C-686/13, *X AB*)

Loss Situations

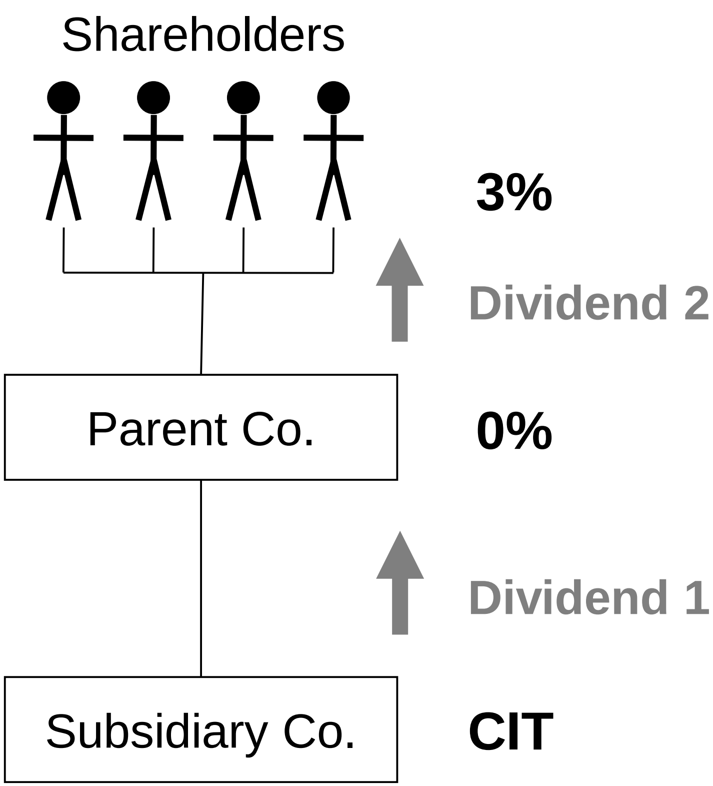
ECJ, 12 February 2009, C-138/07, ***Cobelfret***, [2009] ECR I-732



	Income	(20)
+	Dividend	200
=	***Tax Base 1***	***180***
./.	DRD (95% of the Dividend [= 190], but limited to Base 1 [= 180])	180
=	***Tax Base 2***	***0***

I.e., loss-carry forward would effectively be limited because of the receipt of an "exempt" dividend!

Excursus: The French 3% Distribution Tax



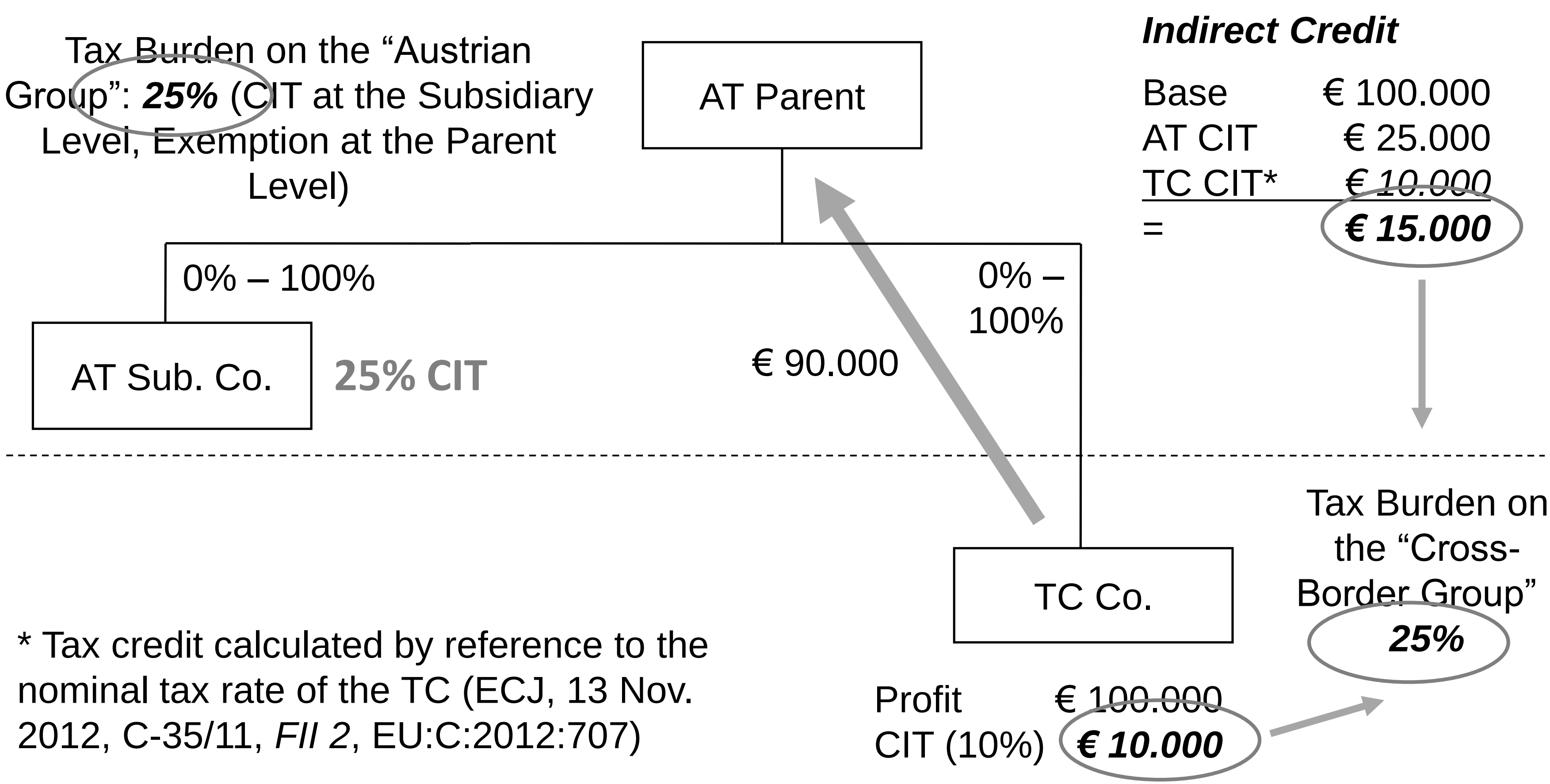
- Withholding Tax? Corporate Tax?
- Similarities with corporation tax (CIT)
  - Additional contribution to CIT
  - Taxpayer: distributing company
  - Assessed & recovered like CIT
- Similarities with a withholding tax
  - Taxable event: dividend payment
  - Taxable basis: amounts distributed
- Permissible under EU Parent-Subsidiary-Directive?

Switch-Over Clauses and Anti-Abuse Measures

- Switch-over from exemption to indirect credit
- Relevance of, e.g.,
  - the country of source,
  - whether foreign income is “active”, and
  - the level of foreign taxation.
- Already discussed in the OECD, Report on Harmful Tax Competition – An Emerging Global Issue (1998)

Switch-Over Clauses

ECJ, 10 February 2011, C-436/08 und C-437/08, ***Haribo and Salinen,*** [2011] ECR I-305



* Tax credit calculated by reference to the nominal tax rate of the TC (ECJ, 13 Nov. 2012, C-35/11, *FII 2*, EU:C:2012:707)

Abbreviations: EU = European Union; EEA = European Economic Area; TC = Third Country.

Switch-Over Clauses and Anti-Abuse Measures

- **Minimum Standard of Anti-Abuse in the EU Parent-Subsidiary-Directive**
  - Introduced by Council Directive (EU) 2015/121 of 27 January 2015, [2014] OJ L 21, p. 1, and based on Action 15 of the EU's Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion, COM(2012)722 final
  - Mandatory "Minimum Standard":

In Directive 2011/96/EU, Article 1(2) is replaced by the following paragraphs:

'2. Member States shall not grant the benefits of this Directive to an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of this Directive, are not genuine having regard to all relevant facts and circumstances.

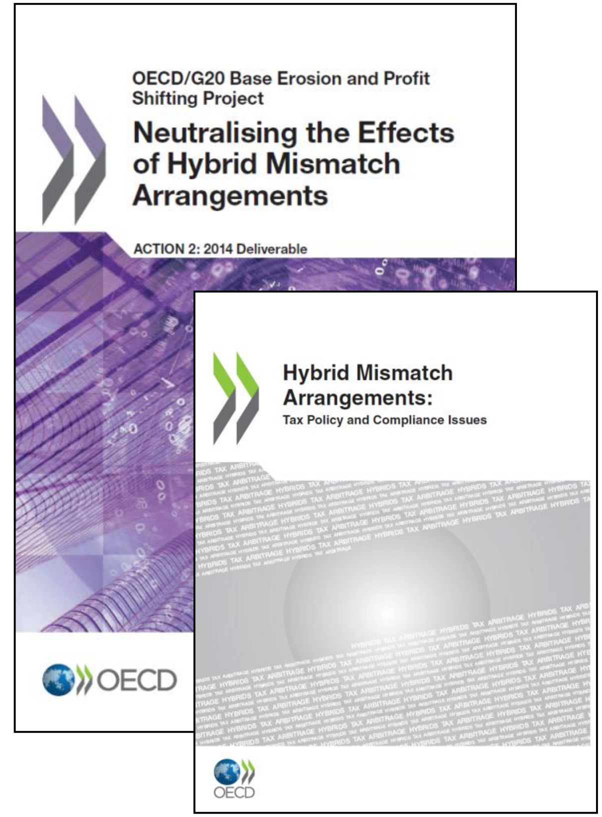
An arrangement may comprise more than one step or part.

3. For the purposes of paragraph 2, an arrangement or a series of arrangements shall be regarded as not genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

4. This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of tax evasion, tax fraud or abuse.'

Hybrid Financial Instruments

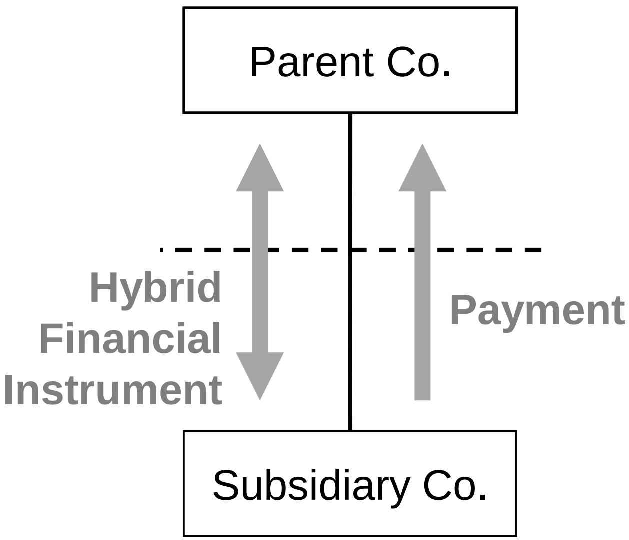
- **Does exemption depend on non-deductibility in the subsidiary's State?**
- **Different characterization of a financial instrument**
  - OECD BEPS Action 2 (Hybrids)
  - Action 14 of the EU's Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion, COM(2012)722 final, and 2014 amendment of the EU Parent-Subsidiary-Directive
  - Unilateral provisions (e.g., Austria: § 10(7) KStG; France: 212,1 CGI; Germany: § 8b KStG, Japan)



Report ***Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues*** (March 2012) and ***BEPS-Deliverable*** (Sept. 2014)

Hybrid Financial Instruments

OECD BEPS Action 2 – "Arrangements that produce deduction/no-inclusion outcomes"



Denial of dividend exemption for deductible payments

67. The first recommendation targets mismatches that arise in respect of the structures identified in Figure 2.1. As noted above, mismatches can arise in respect of payments made under a financial instrument that is a debt / equity hybrid. This difference in characterisation often results in a payment of deductible interest by the issuer being treated as a dividend which is exempted from the charge to tax in the holder's jurisdiction or subject to some other form of equivalent tax relief.

68. A country that provides for a dividend exemption specifically to relieve economic double taxation on distributed profit should restrict such exemption to payments that are paid out of after-tax profits. In a wholly-domestic situation this outcome can generally be achieved by restricting the dividend exemption to payments that are characterised as dividends or distributions under domestic law. In cross-border payment situations, however, such a restriction will not be sufficient, as the domestic criteria characterising the payment and determining its tax treatment will not apply to the payer. Jurisdictions that relieve economic double taxation by offering a dividend exemption for amounts paid by a foreign payer should therefore similarly limit the benefit of the dividend exemption to payments that are paid out of after-tax profits.

Hybrid Financial Instruments

- **"Mandatory Taxation" in the EU Parent-Subsidiary-Directive**
  - Introduced by Council Directive 2014/86/EU of 8 July 2014, [2014] OJ L 219, p. 40, and based on Action 14 of the EU's Action Plan to Strengthen the Fight against Tax Fraud and Tax Evasion, COM(2012)722 final
  - Background : "In as far as payments under a hybrid loan arrangement are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption" (Report of the Code of Conduct Group of 25 May 2010, Doc. 10033/10, FISC 47).
  - Mandatory Taxation of Deductible Payments:

(1) in Article 4(1), point (a) is replaced by the following:

'(a) refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary; or';

Participation Relief in Switzerland

- **Scope**
  - Open / hidden Dividends & Capital Gains from Swiss / non-Swiss Subsidiaries
- **Requirements**
  - No minimum Pre-Tax at Sub
  - No Deduction at Sub Level
  - Dividends
    - Min. 10% SH / FMV 1m
  - Capital Gains
    - Min. 10% SH & 1 Year Holding
- **Calculation**
  - Gross Income, minus Finance-, Adminstrative-Expenses (5%), Amortization
- **Relief**
  - Reduction of CIT in % of net Participation Income / net overall Income
- **Peculiarities**
  - Loss Carry-Forward off-set
  - No Carry-Forward of Excess Relief
  - “Balooning”

Question 5

?

- **Do You Predict that in Your Country it Will Become Harder to Qualify for the Participation Exemption?**

Conclusions

Conclusions

- **How do we trade-off the competing goals underlying exemption?**
- **Is credit a competitive disadvantage?**
- **Is participation exemption as a structural necessity or a privilege?**
- **Are the OECD and EU on the right rrack?**
- **Is the effectiviness of the participation exemption increasing?**

Question 1 ... Again!

?

- **Is the Participation Exemption Effective?**