

Indirect Credit versus Exemption: Double Taxation Relief for Intercompany Distributions

In the 2011 Klaus Vogel Lecture, Professor Georg Kofler examined the trend towards exemption for dividends on direct investment and permanent establishment profits, which Professor John Avery Jones had raised in his Klaus Vogel Lecture on the origins of credit versus exemption in relation to avoiding double taxation.

1. Introduction

Professor Avery Jones has identified the trend towards exemption with regard to the double taxation relief of dividends on direct investments and noted that “the trend creates its own momentum because taxpayers under a credit system feel at a disadvantage when all the competitors are under an exemption system”.¹ This contribution explores this trend by identifying the cause for the relevant economic double taxation, the normative framework for taxation of distributed profits, the practical considerations that guide countries in determining their tax policy, and, finally, the historical and current discussions at the OECD and in the European Union.

2. Triple Double Taxation

The issue of economic double taxation of intercompany distributions across borders exists because countries generally treat legally independent subsidiaries of domestic parent companies as separate taxable entities. A subsidiary’s income is, therefore, generally not taxable in the parent’s state of residence until remitted to the parent, for example, as a dividend. Indeed, no OECD Member country or EU Member State employs a system that, as a general matter, immediately includes profits of a foreign subsidiary in the parent’s income.² It is, hence, commonly said that residence-based corporate taxation is “deferred”³ until the moment when profits are repatri-

ated, unless certain “anti-deferral rules”, for example, controlled foreign company (CFC) legislation, provide for an immediate inclusion of income earned through a foreign legal entity.⁴ Given “deferral”, it is also often argued that exemption and indirect credit yield quite similar results in their actual operation.⁵

From the perspective of juridical and economic double taxation, three variations need to be distinguished. The first level of tax generally arises when the subsidiary is taxed by its state of residence on its income. Once profits are distributed, generally a second level of tax, usually in the form of a withholding tax, is levied on the distributed profits by the source state according to its domestic law on the recipient parent company. Hence, unless such tax is eliminated in the source state, for example, by a tax treaty through an exemption from withholding, by article 5 of the Parent-Subsidiary Directive (1990)⁶ or as a consequence of the jurisprudence of the European Court of Justice (ECJ) on the fundamental freedoms,⁷ it is said that

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 judgment that presupposes the outcome of the discussion. See K. Vogel, *Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part I)*, 16 *Intertax* 8-9, p. 218 (1988).

4. See, for example, US Department of the Treasury, *Approaches to Improve the Competitiveness of the US Business Tax System for the 21st Century* p. 85 et seq. (20 Dec. 2007) and US Joint Committee on Taxation, *Present Law and Issues in US Taxation of Cross-Border Income*, JCX-42-11, p. 46 et seq. and p. 69 et seq. (6 Sept. 2011).
5. M.J. Graetz & M.M. O’Hear, *The “Original Intent” of US International Taxation*, 46 *Duke L. J.* 5, pp. 1064-1065 (1997).
6. EU Parent-Subsidiary Directive (1990): Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 6 (1990), as amended, EU Law IBFD.
7. Under the ECJ’s case law, a source state that chooses to relieve domestic economic double taxation of distributed profits for its residents must extend this relief to non-residents to the extent that a similar domestic economic double taxation results from the exercise of its tax jurisdiction over these non-residents, for example, where the source state subjects company profits first to corporation tax and then to a withholding tax on distribution and, therefore, puts non-residents in an objectively comparable situation (see UK: ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue*, ECJ Case Law IBFD; FR: ECJ, 14 Dec. 2006, Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l’Économie, des Finances et de l’Industrie*, ECJ Case Law IBFD; NL: ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v. Inspecteur van de Belastingdienst/Amsterdam*, ECJ Case Law IBFD; NL: ECJ, 11 June 2009, Case C-521/07, *Commission of the European Communities v. Kingdom of the Netherlands*, ECJ Case Law IBFD; FI: ECJ, 18 June 2009, Case C-303/07, *Aberdeen Property Fininvest Alpha Oy*, ECJ Case Law IBFD; IT: ECJ, 19 Nov. 2009, Case C-540/07, *Commission of the European Communities v. Italian Republic*, ECJ Case Law IBFD; ES: ECJ, 3 June 2010, Case C-487/08, *European Commission v. Kingdom of Spain*, ECJ Case Law IBFD; and PT: ECJ, Order, 22 Nov. 2010, Case C-199/10, *Secilpar – Sociedade Unipessoal SL v. Fazenda Pública*, ECJ Case Law IBFD). This obligation to provide relief, for example, to exempt from or refund withholding tax, exists with regard to individual as well as corporate shareholders, but, of course, specifically outside the scope of the Parent-Subsidiary Directive (1990). This obligation is neither dependent on taxation in the shareholder’s residence state (*Aberdeen Property* (C-303/07), at para. 52) nor called into question by the fact

* Professor of Tax Law, Johannes Kepler University, Linz, Austria. The author wishes to thank Dieter Endres and Jürgen Lüdicke from PricewaterhouseCoopers, Germany, and Michael Lang from the Institute for Austrian and International Tax Law, WU Vienna, for the invitation to speak at the Klaus Vogel Lecture, and John F. Avery Jones, Werner C. Haslehner, Yoshihiro Masui, Alexander Rust, Gottfried Schellmann and Rita Szudoczky for their helpful comments and input in the writing of this article. He can be contacted at georg.kofler@jku.at.

1. J.F. Avery Jones, *Avoiding Double Taxation: Credit versus Exemption – The Origins*, 66 *Bull. Intl. Taxn.* 2, sec. 9. (2012), *Journals IBFD*.
2. See Advisory Panel on Canada’s System of International Taxation, *Enhancing Canada’s International Tax Advantage* para. 2.13 (Apr. 2008).
3. This term has been criticized by Klaus Vogel who pointed out the biased terminology that “implies that income of a foreign-based subsidiary properly should be taxed in the parent’s country when accrued and that this taxation is only ‘deferred’”, which he considered to be a value

the source state creates (domestic) economic double taxation and, indeed, it is, within the stated limits, in its own discretion as to whether or not such economic double taxation should persist.

However, if the state of the parent company treats the distribution as taxable income of the parent, this third level of tax would lead to juridical and (cross-border) economic double taxation. Juridical double taxation is created through the combination of withholding taxation in the source state and residence taxation in the parent state and is generally relieved within the framework of articles 10 and 23 of the OECD Model (2010)⁸ through a (direct) credit. However, the (cross-border) economic double taxation, which exists because the distributed profits are taxed once at the level of the subsidiary and again as dividend income at the level of the parent company in its state of residence, is generally not addressed by tax treaties.⁹ It is, hence, for domestic law to decide whether or not and which measures should be implemented to provide relief. Even in the European Union, the Parent-Subsidiary Directive (1990) only dictates that relief must be given in cases of substantial, i.e. 10%, shareholdings, but leaves the choice between exemption and indirect credit, i.e. “credit for underlying taxes” or “deemed-paid credit”, to the Member States.¹⁰ This contribution addresses the issues and considerations underlying that choice.

3. Normative Framework: “Battle of Neutralities”

From a tax policy perspective, taxes should be “neutral”, i.e. not distort economic decisions. As taxation (nearly) necessarily distorts some decisions, several (conflicting) economic concepts have been developed by economists in respect of the taxation of foreign investment (in whatever legal form)¹¹ with a focus on which decisions should not be distorted by taxation. Intensive official discussions with regard to neutrality issues were and are predomi-

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that the source state may not tax subsequent distributions by the foreign parent company in its residence State (*Commission v. Italy* (C-540/07), at paras. 42 et seq. and 56). However, according to the ECJ’s case law, treaty relief from the source country taxation of the shareholder, i.e. the relief from juridical double taxation from the residence state’s perspective, may “neutralize” the discriminatory effects of a non-extension of the source state’s relief, i.e. the relief from domestic economic double taxation from the source state’s perspective. (On this, see G. Kofler, *Tax Treaty “Neutralization” of Source State Discrimination under the EU Fundamental Freedoms?*, 65 Bull. Intl. Taxn. 12 (2011), Journals IBFD, with further references). In any event, the source state is not obliged to do more than provide relief from domestic economic double taxation. It does not need to forego part of the corporate tax levied on the profits of the distributing company, as this “would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory” (*ACT Group Litigation* (C-374/04), at para. 59).

8. OECD Model Tax Convention on Income and Capital (22 July 2010), Models IBFD.

9. See sec. 5.

10. For brief references to the ECJ’s position on this issue, see sec. 5.

11. For the irrelevance of legal form for the economic consequences see, for example, Vogel, *supra* n. 3, at p. 319.

nantly to be found in Canada,¹² the United Kingdom¹³ and the United States,¹⁴ whereas other countries seem to primarily focus on other aspects, such as competitiveness, simplicity and fairness. Indeed, as the General Reporters for the 2011 IFA Congress noted:¹⁵

These academic debates have resulted in endless and spurious controversies, as shown by an overly abundant literature discussing the comparable merits of each proposed system. However interesting these debates might be, the “battle of neutralities” is counterproductive and cannot usefully help policy-makers to improve the international tax environment. As evidenced by the current position of the OECD and the European Court of Justice (ECJ), neither of which expresses a clear preference for a particular method, there is and will probably never be sufficient evidence to ever reach a consensus on what form of neutrality is in the best interest of the international community.

The “battle of neutralities” has led to an extensive amount of literature and theoretical discussion,¹⁶ most of which, of course, is based on underlying and not as yet empirically tested assumptions, and is not clearly reflected in existing tax systems. A short review of the “neutralities” nevertheless seems useful if only to demonstrate the theoretical shortcomings for the area of corporate taxation. It may also show that “capital export neutrality” (CEN), though theoretically achievable unilaterally, is unrealistic in the current tax environment as it would require immediate taxation and unlimited indirect credits, while “capital import neutrality” (CIN) as well as “capital ownership neutrality” (CON) would, indeed, require the similarly unrealistic situation that all countries adopted a certain system.

The normative goal behind CEN is that tax considerations should not influence whether resident investors invest their capital at home or abroad. If an investor’s capital income is taxed at the same total rate wherever the income is earned, location-based tax incentives are removed and business considerations (pre-tax returns)

12. See, for example, Advisory Panel on Canada’s System of International Taxation, *supra* n. 2. See also M.P. Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, Research Report Prepared for the Advisory Panel on Canada’s System of International Taxation (July 2008).

13. M. Waters, *Double Taxation Relief for Companies: A Discussion Paper* (UK Inland Revenue 1999).

14. See, for example, US Department of the Treasury, *supra* n. 4 and US Joint Committee on Taxation, *supra* n. 4, at p. 69 et seq.

15. G. Blanluet & P. J. Durand, *General Report, in Key practical issues to eliminate double taxation of business income, Cahiers de droit fiscal international* Vol. 96b, sec. 1.2. (Sdu Uitgevers 2011), Online Books IBFD.

16. For recent comprehensive discussions see US Department of the Treasury, *supra* n. 4, at pp. 56-57 and US Joint Committee on Taxation, *supra* n. 4. See also M.J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev., p. 270 et seq. (2001); M.A. Kane, *Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks*, 26 Va. Tax Rev., p. 53 (2006) and *Commentary Considering “Reconsidering the Taxation of Foreign Income”*, 62 Tax L. Rev., p. 299 (2009); F. Shadeen, *International Tax Neutrality: Reconsiderations*, 27 Va. Tax. Rev., p. 203 (2007) and *International Tax Neutrality: Revisited*, 64 Tax L. Rev., p. 131 (2011); W. Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World Tax J. 1, sec. 2.3. (2009), Journals IBFD; J.R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 Tax L. Rev., p. 269 (2009); S.E. Shay, *Commentary Ownership Neutrality and Practical Implications*, 62 Tax L. Rev., p. 317 (2009); and M.S. Knoll, *Reconsidering International Tax Neutrality*, 64 Tax L. Rev., p. 99 (2011). For a comprehensive discussion for a legal perspective see K. Vogel, *Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part II)*, 16 Intertax 10, pp. 311-315 (1988).

rather than tax considerations determine the location of investments. This enhances efficiency because seeking the greatest pre-tax rate of returns leads to a more efficient global allocation of capital, but is also based on the implicit, and not unchallenged, assumption that investment by domestic corporations comes from a fixed pool of capital available to the domestic corporate sector. CEN, in promoting global economic efficiency, is, hence, indifferent not only as to where investments are made but also as to which government collects the tax revenues from the income of the investment. However, CEN faces inherent limits in taxation practice, as it would require a true worldwide tax system that would guarantee that all investors pay tax at their home country rate on all income regardless where it arises.¹⁷ As source countries do not waive source taxation, this would imply a system with immediate taxation of foreign income, i.e. no “deferral”, and a full credit,¹⁸ both of which are not found in real-world tax systems.¹⁹ Indeed, “deferral” is a common feature, even in existing worldwide tax systems, and credit limitations generally exist to bar foreign taxes from offsetting tax on domestic source income.²⁰ The hybrid systems existing in reality are, hence, sometimes described as a “defensive neutrality” that “imposes on companies a disincentive to invest abroad in high-tax countries”.²¹ Moreover, CEN might not be a reliable standard for corporate taxation. If the corporate tax were considered to be “justified as a backstop for shareholder taxation, it is problematic to regard the corporate residence, which in addition might be easily manipulated, as decisive for the application of the CEN concept whenever the shareholders are not situated in the country of incorporation or the country where the corporate head office resides”, as, in such a situation, the investment options are then not restricted to domestic versus foreign investment by the company, but also include distributions and alternative investments by shareholders.²²

“National neutrality” (NN) misleadingly implies a form of neutrality in that all net receipts received by residents are taxed the same regardless of whether or not they have also been taxed by another nation. This, however, favours domestic investments over equally productive foreign investments in that foreign taxes are viewed as mere costs of investing abroad and, consequently, only a deduction for foreign taxes, as for other foreign costs, such as labour, is given in computing taxable income. While NN may, in the short term, further national interests and well-being, many argue that NN is doomed to fail on its own terms in the long run if one considers likely responses by foreign

governments,²³ and that the assumption of maximization of national welfare by subjecting foreign income to taxation with only deductions for foreign tax payments does not hold if greater investment abroad would give rise to greater investment by foreign firms in the residence country.²⁴ Hence, there is broad agreement that national interests are best pursued by a system designed to promote worldwide economic efficiency.²⁵

The normative goal of CIN is that tax considerations should not influence whether or not a particular investment is made by domestic or foreign investors, i.e. that business considerations rather than tax considerations determines who makes a certain investment, and that it enhances efficiency because inefficiencies in the structure of cross-border holdings are reduced.²⁶ Traditionally, and so still broadly understood in the tax world,²⁷ CIN is about competitiveness, i.e. that “all investors who invest in one particular country are subject to the same tax treatment, namely, that of the country of the source of investment income, would allow all foreign investors in that country equal opportunities for expansion”.²⁸ This neutrality is, hence, based not on absolute terms, but, rather, on tax neutrality in relative terms of competition and has been extended to competition for equity financing.²⁹ Moreover, CIN can be understood as requiring keeping neutral the question as to where capital invested in the taxing jurisdiction should be imported from, i.e. as representing neutrality as to the location or origin of investors.³⁰ CIN can be achieved through a source-based taxation by all countries, i.e. the worldwide application of the exemption method, unless source states discriminate between domestic and foreign investment. CIN’s competition aspect, however, presupposes a unity of state, territory and markets, i.e. that establishment primarily addresses the local supplier and customer base, which is no longer the case in the current world, especially with regard to research and development and the creation of intangibles that are subsequently exploited worldwide.³¹

17. Hence, CEN is sometimes equated with horizontal equity. See K. Nelson Moore, *The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal*, 7 Am. J. Tax Policy, p. 210 together with footnote 5 (1988).

18. See, fundamentally, P.B. Musgrave, *United States Taxation of Foreign Investment Income* pp. 74-75 (Harvard Law School 1969) and US Joint Committee on Taxation, *supra* n. 4, at pp. 69-70.

19. See, for example, for the United Kingdom, the discussion in Waters, *supra* n. 13, at paras. 3.13-3.14.

20. For the historical roots of the credit limitation in the United States, see Graetz & O’Hear, *supra* n. 5, at pp. 1054-1056.

21. E.R. Larkins, *Double Tax Relief for Foreign Income: A Comparative Study of Advanced Economies*, 21 Va. Tax Rev., p. 247 (2001).

22. Schön, *supra* n. 16, sec. 2.3.2.

23. Graetz & O’Hear, *supra* n. 5, at pp. 1042-1043 and Schön, *supra* n. 16, at sec. 2.3.5.2.

24. See Hines, *supra* n. 16, at p. 275.

25. Graetz, *supra* n. 16, at pp. 275, 281 and 292 (2001) and D. Shaviro, *Why Worldwide Welfare as a Normative Standard for US Tax Policy?*, 60 Tax L. Rev., p. 155 (2007). See also, for example, Graetz & O’Hear, *supra* n. 5, at p. 1043.

26. See R. Mason, *Tax Expenditures and Global Labor Mobility*, 84 N.Y. U. L. Rev., pp. 1569-1572 (2009).

27. For the alternative economic understanding of CIN with regard to the savings-consumption-decision, see Knoll, *supra* n. 16, at p. 107 et seq. and 119 and Shadeen, *International Tax Neutrality: Revisited*, *supra* n. 16, at pp. 138-139.

28. P.B. Richman, *Taxation of Foreign Investment Income: An Economic Analysis* p. 8 (Johns Hopkins Press 1963). See also Larkins, *supra* n. 21, at pp. 249-250; Devereux, *supra* n. 12, at p. 9; and Knoll, *supra* n. 16, at p. 107 et seq.

29. US Joint Committee on Taxation, *supra* n. 4, at pp. 72-73.

30. Shadeen, *International Tax Neutrality: Revisited*, *supra* n. 16, at p. 136.

31. Schön, *supra* n. 16, at sec. 2.3.3.

Neutrality	Standard	Benchmark	Assumption	Achieved by
Location of investment	Capital export neutrality (CEN)	Neutrality with regard to domestic and foreign investments producing the same pre-tax rate of return	Investment by domestic corporations comes from a fixed pool of capital available to the domestic corporate sector	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
Origin of investment	Capital import neutrality (CIN)	Neutrality with regard to whether an investment is made by a foreign or a domestic investor, i.e. equality of the after-tax rate of return for each investor	Capital is supplied at a fixed rate by the integrated world capital market	Adoption by all countries of the exemption method
Identity of investors	Capital ownership neutrality (CON)	Neutrality with regard to which corporation owns and exploits capital assets, i.e. corporations that exploit a given asset most efficiently are willing to pay the most to own that asset		Adoption by <i>all</i> 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	

For CON, which was only recently added to the discussion³² and may be viewed as a subset of CIN,³³ the critical new assumptions are that either funds may be raised infinitely to capture economic rents or that foreign-owned domestic investment replace domestic capital invested abroad,³⁴ and that the productivity of capital depends on, and varies with, the identity of its owner. Hence, an efficient tax system is one that encourages the most productive ownership of capital. Such neutrality, even if there were empirical proof for the assumed superior relevance of ownership would, however, require global conformity in tax systems, either by all countries adopting source-based taxation (because then all investors will be subject to the source country's tax rate regardless of their residence) or all countries adopting residence-based taxation (because ownership would then be determined by productivity differences and not tax differences).³⁵ A variant, "national ownership neutrality" (NON) favours territoriality based on the argument that such policy would maximize a jurisdiction's own welfare in terms on domestic tax

revenue and after-tax income to home country firms, as opposed to worldwide welfare.³⁶ Proponents of NON also argue that general expenses, such as interest and general administrative overhead, should "not be allocated at all" between domestic and foreign income, but instead should be deductible in the residence state of the parent company.³⁷

The Table above provides a brief overview of the different neutrality standards.

4. Country Practice: Competitiveness

Let us briefly focus on the double taxation side of this issue. Economic double taxation of corporate profits is different from juridical double taxation and depends on domestic policy choices if and how it should be removed. This policy choice may also be made in domestic settings. Closely tied to the theoretical justification of the corporate tax itself,³⁸ there is currently broad and international agreement that taxable income should not bear multiple

32. See M.A. Desai & J.R. Hines Jr., *Evaluating International Tax Reform*, 56 Natl. Tax J., p. 487 (2003) and *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 Natl. Tax J., p. 937 (2004), and J.R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 Tax L. Rev., p. 269 (2009).

33. Shadeen, *International Tax Neutrality: Revisited*, *supra* n. 16, at p. 136.

34. For an overview of recent empirical studies see US Joint Committee on Taxation, *supra* n. 4, at p. 78.

35. Desai & Hines Jr., *Evaluating International Tax Reform*, *supra* n. 32, at p. 495.

36. For a critical analysis, see Kane, *Commentary Considering "Reconsidering the Taxation of Foreign Income"*, *supra* n. 16, at pp. 300-304.

37. Hines, *supra* n. 32, at pp. 282-285. For a critical analysis, see Kane, *Commentary Considering Reconsidering the Taxation of Foreign Income*, *supra* n. 16, at pp. 312-315 and Shay, *supra* n. 16, at pp. 324-326.

38. See, for example, C.A.L. Rasenack, *Die Theorie der Körperschaftsteuer* (Duncker & Humblot 1974). For a more recent discussion of the justification of the corporate tax, see Y. Brauner, *The Non-Sense Tax: A Reply to New Corporate Income Tax Advocacy*, Mich. St. L. Rev., p. 591 (Summer 2008).

levels of corporate tax domestically.³⁹ Indeed, such measures were already introduced in early stages of domestic taxation of corporations. For example, the United Kingdom has effectively not taxed dividends at the level of the recipient company since 1803,⁴⁰ the Netherlands since 1893⁴¹ and, in 1918, the United States enacted a dividends received deduction.⁴² Austria employs a participation exemption since 1920,⁴³ as has Germany since 1920,⁴⁴ with an imputation interlude from 1977 to 2000.⁴⁵ Japan introduced an exemption system in 1950.⁴⁶ Finally, Australia had a dividend rebate system from 1936⁴⁷ until

it switched to imputation in 2002.⁴⁸ It is, hence, noteworthy that, in domestic situations, multiple layers of corporate taxation are generally avoided and that this is predominantly done through the exemption method or a dividends received deduction, whereas few countries still employ imputation in intercompany situations domestically. An illustrative example is the Japanese move from the full double taxation to the exemption of intercompany dividends in domestic settings since 1950, which was based on the 1949 Report of the *Shoup* Mission that has clearly set out its reasons:⁴⁹

At present dividends received by a corporation from another corporation are included in the taxable income of the recipient corporation. This means that where one corporation owns shares in another a heavier tax is imposed than when a distribution of profits is made directly to the ultimate individual shareholder without passing through one or more intermediate corporations.

In general, there is no reason to discriminate in this extent against the use of subsidiary corporations, or holding companies, or the ownership generally by corporations of stock in other corporations. Indeed, there are many situations in which such arrangements constitute the most rational and effective mode of organization for the carrying on of business. Particularly in international trade, the setting up of subsidiaries to handle the affairs of a business in foreign countries has many advantages. Such a tax penalty on these arrangements is accordingly undesirable.

To be sure, there are occasions where the piling up of holding companies, and particularly the pyramiding of control, produces concentrations of power and complicated interrelationships that may be considered undesirable. But a blanket tax penalty on all such intercorporate relationships is hardly a wise or effective way of curbing these abuses: if they are to be curbed it will have to be by more direct and selective means.

Accordingly, we recommend that all extra burdens on the holding of shares by corporations and on the payment of intercorporate dividends be removed as far as possible. For the income tax, we recommend that this be done very simply by excluding, from the net taxable income of corporations, all dividends received from other taxable domestic corporations. This will avoid the double taxation of intercorporate dividends and at the same time ensure that an adequate tax is collected from corporations. This will also tie in very readily with provisions for the carryover or carry back of losses, since only the taxable income need be considered for such purposes, and the dividends received can be left out of account altogether.

With regard to cross-border intercompany distributions, country practice shows that factors other than neutrality are considered in designing tax systems, and, as Professor Avery Jones has pointed out,⁵⁰ that the choice of method is influenced by the general approach of a jurisdiction as to how to avoid juridical double taxation. From

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39. For US: Act 1909, see the analysis by G. Mundstock, *Taxation of Intercorporate Dividend Under an Unintegrated Regime*, 44 Tax L. Rev. 1, p. 5 (1988).
40. For a discussion of the developments before the 1965 reform, see P.A. Harris, *Corporate/Shareholder Income Taxation* p. 769 et seq. (IBFD 1996) and J.F. Avery Jones, *Defining and Taxing Companies 1799 to 1965*, in *Studies in the History of Tax Law* p. 5 (J. Tiley ed., Hart Publishing 2011). For the subsequent rules, see UK: Finance Act 1965, sec. 47 (no ownership requirement); UK: Income and Corporation Taxes Act 1970, sec. 239 (no ownership requirement); UK: Income and Corporation Taxes Act 1988, sec. 208, National Legislation IBFD (no ownership requirement); and UK: Corporation Tax Act 2009, sec. 1285, National Legislation IBFD (no ownership requirement).
41. See A. Hamulyák, *Netherlands: Revision of the Participation Exemption*, 27 Eur. Taxn. 10, sec. I. (1987).
42. US: Revenue Act of 1918, 40 Stat. 1078 sec. 234(a)(6), (100% dividends received deduction (DRD), with no holding requirement). See also, for example, US: Revenue Act of 1934, 48 Stat. 720, sec. 23(p). For a discussion of the taxation of inter-corporate dividends before the Revenue Act of 1918, see Mundstock, *supra* n. 39, at pp. 4-7 (1988). See again US: Revenue Act of 1935, 49 Stat. 1014, sec. 102(h) (90% DRD, with no minimum ownership requirement) and US: Revenue Act of 1936, 49 Stat. 1648, sec. 26(b) (85% DRD, with no minimum ownership requirement). See also, for example, US: Internal Revenue Code of 1954, 68 Stat. 730, sec. 243. For a discussion of the consolidated return rules since US: Revenue Act of 1942, 56 Stat. 858 that effectively led to a 100% DRD, see Mundstock, *supra* n. 39, at pp. 10-11. Finally, see US: Revenue Act of 1986, 100 Stat 2249, sec. 611(a)(1) (amending sec. 243(a)(1), with an 80% DRD) and US: Revenue Act of 1987, 101 Stat. 408, Sec. 10221 (amending US: Internal Revenue Code of 1986, sec. 243) (70% deduction for ownership below 20% (Sec. 243(a)(1)), 80% deduction for ownership of at least 20% (Sec. 243(c)) and 100% deduction within an affiliated group, i.e. 80% ownership (Sec. 243(a)(3))).
43. AT: art. V, sec. 2 of the 1920 amendment to the AT: PersStG, StGBI 1920/372/1920 (20% of dividends taxable), subsequently DE: KStG 1934, RGBI I 1934, 1031, sec. 9 Abs 1, made applicable in Austria by AT: RGBI I 1938, 1817 (25% ownership requirement) and then transferred into Austrian law by AT: StGBI 1945/12, AT: KStG 1966, BGBl 1966/156, sec. 10 Abs 1 (25% ownership requirement) and, currently, AT: KStG 1988, BGBl 1988/401, sec.10, National Legislation IBFD, as amended (no ownership requirement).
44. DE: KStG 1920, RGBI 1920, 281, sec. 6 Nr. 8 (20% ownership requirement); DE: KStG 1925, RGBI I 1925, 208, sec. 11 Z 3 (25% ownership requirement) and DE: KStG 1934, RGBI I 1934, 1031, sec. 9 Abs 1 (25% ownership requirement). For a historical overview, see H.G. Ruppe, *Die steuerliche Doppelbelastung der Körperschaftsgewinne* pp. 32-50 (Jupiter Verlag 1967) and, for the subsequent rules, see DE: KStG, sec. 8b(1), National Legislation IBFD, as amended by DE: StSenkG, BGBl I 2000, 1433 (no ownership requirement and 100% exemption) and sec. 8b(5) of the KStG, as amended by DE: ProtErklG, BGBl I 2003, 2840 (deeming 5% of the dividend to be a non-deductible expense).
45. Introduced by DE: KStG 1977, BGBl I 1976, 2597, and repealed by StSenkG, BGBl I 2000, 1433.
46. JP: Corporate Tax Act, art. 23, National Legislation IBFD (25% ownership requirement, reduced to exemption of 80% since 1998 and 50% since 2002 for ownership of less than 25%). See also Y. Masui, *International Taxation in Japan: A Historical Overview*, 21 Tax Notes Intl., pp. 2814-2815 (18 Dec. 2000) and N. Matsuda & S. Ino, *Japan, in Trends in company/shareholder taxation: single or double taxation?*, *Cahiers de droit fiscal international* Vol. 88a, sec. 2. (Kluwer L. Intl. 2003), Online Books IBFD.
47. AU: Income Tax Assessment Act, 1936, secs. 46 and 46A, National Legislation IBFD ("dividend rebate", i.e. a rebate for taxes attributable to intercompany dividends). For this and the previous rules, see M.L. Weissman, *Company Taxation in Australia*, 13 U. Toronto L. J., p.

202 (1960) and P. von Nessen, *Australian Taxation of Companies and Shareholders: Imputation Arrives Down Under*, 19 Case W. Res. J. Intl. L., p. 76 (1987).

48. While the general imputation system was introduced by AU: Taxation Laws Amendment (Company Distributions) Bill, 1987, resident companies that received a franked dividend from another company included the net amount of the dividend in assessable income and were eligible for an intercorporate dividend rebate. Since 2002, corporations use the same gross-up and credit method as resident individuals; see the Explanatory Memorandum on the Taxation Laws Amendment (Company Distributions) Bill 1987 and the Australian Taxation Office, *Imputation reference guide* (2004).
49. Vol. I, chap. 6, sec. E, Report on Japanese Taxation by the *Shoup* Mission (General Headquarters, Supreme Commander for the Allied Powers, Tokyo, Japan, Sept. 1949).
50. Avery Jones, *supra* n. 1.

a technical tax perspective, the foremost goal of giving relief for underlying corporate taxation is the same as the rationale for granting exemption or a tax credit generally, i.e. to avoid double taxation of income. Many countries have implemented such measures in their domestic laws, albeit sometimes long after, and different from, those for domestic intercompany dividends and/or provide for such relief in tax treaties.⁵¹ A short overview illustrates this point. While the United States had already enacted a general indirect credit in 1918,⁵² the United Kingdom only followed suit in 1950⁵³ and switched to exemption in 2009.⁵⁴ Similarly, Japan introduced an indirect credit in 1962⁵⁵ and switched to exemption in 2001,⁵⁶ and Germany did so in 1972⁵⁷ and switched to exemption in 2001.⁵⁸ Australia, on the other hand, used a “dividend rebate” system for cross-border distributions from 1963 to 1987,⁵⁹ then switched to the indirect credit system⁶⁰ and

moved to exemption in 1991.⁶¹ The Netherlands, Luxembourg and Austria enacted a participation exemption right away in 1914,⁶² 1968⁶³ and 1972,⁶⁴ respectively.

As the US Supreme Court noted with regard to the indirect or “deemed paid” credit, which was enacted as early as 1918,⁶⁵ this measure protects domestic corporations that operate through foreign subsidiaries from double taxation, first, by the foreign jurisdiction, when the income is earned by the subsidiary and, second, by the United States, when the income is received as a dividend by the parent.⁶⁶ In addition, the indirect credit rules have been described as being intended to eliminate the disparity that would otherwise exist between foreign branches and foreign subsidiaries of US corporations,⁶⁷ i.e. the indirect credit rules provide certain US taxpayers earning foreign-taxed income through foreign corporations with a credit corresponding to the direct credit that would be available to a US taxpayer earning foreign-taxed income through a branch.⁶⁸ The same argument, of course, holds with regard to the exemption method and, in both cases, it is a domestic policy judgement as to which amount of ownership of a foreign subsidiary should be likened to the operation through a permanent establishment (PE).⁶⁹ It might, however, be noted in passing that foreign subsidiaries and foreign branches are not always accorded like treatment. For example, the Japanese reform did

51. For an older overview of the German “*Schachtelprivileg*” in tax treaties, see, for example, K. Vogel, *Klaus Vogel on Double Taxation Conventions*, art. 23 m.nos. 97 et seq. (Kluwer 1997) and, for a recent discussion, see J. Lüdicke, *Exemption and Tax Credit in German Tax Treaties*, in *Tax Polymath, Essays in Honour of John F. Avery Jones* sec. 3.2.4. (P. Baker & C. Bobbett eds., IBFD 2010), Online Books IBFD.

52. Sec. 240(c) of the Revenue Act of 1918, 40 Stat. 1078 (holding requirement of the majority of the voting stock); sec. 131(f) of the Revenue Acts of 1936 and 1938, 49 Stat. 1648, 1696; 52 Stat. 447, 506 (holding requirement of the majority of the voting stock); sec. 902 of the Internal Revenue Code of 1954, 68 Stat. 730 (10% voting stock ownership requirement); and, currently, sec. 902 Internal Revenue Code of 1986, 100 Stat. 2528 (10% voting stock ownership requirement).

53. First enacted in UK: Finance Act 1950, sec. 36 and sch. 6 (50% ownership requirement for holdings in companies of non-Commonwealth countries, subsequently reduced to 25% in 1964 and 10% in 1971. For an overview of the UK developments, see Waters, *supra* n. 13, at pp. 48-54 and now in UK: Taxation (International and Other Provisions) Act 2010, secs. 8-17 (10% ownership requirement). However, credit relief for distributions that are exempt under part 9A of the Corporation Tax Act 2009 has been withdrawn, except where, as a result of an election under sec. 931R, the distribution remains taxable. See M. Kayser & G. Richards, *United Kingdom*, in *supra* n. 15, at sec. 1. See also UK: Finance (No.2) Act of 1945, sec. 51 and sch. 7 (dealing with indirect tax credits available under a double taxation treaty).

54. Part 9A of the Corporation Tax Act 2009 (UK: Finance Act 2009, sch. 14, National Legislation) (since 1 July 2009, and only for large- and medium-sized companies).

55. Art. 69 Corporate Tax Act (25% ownership requirement). See Masui, *supra* n. 46, at pp. 2815-2816 and Matsuda & Ino, *supra* n. 46, at sec. 3.2.2.

56. Art. 23-2 Corporate Tax Act (95% exemption). See Y. Masui, *Taxation of Foreign Subsidiaries: Japan's Tax Reform 2009/10*, 64 Bull. Intl. Taxn. 4 (2010), Journals IBFD and T. Miyatake, *Japan's Foreign Subsidiaries' Dividends Exclusion*, in Baker & Bobbett, *supra* n. 51.

57. Sec. 19a(2)-(5) of the KStG, as introduced by DE: *Außensteuerreformgesetz*, BGBl I 1972, 1713 (requiring active income and 25% ownership requirement, reduced to 10% by the DE: StEntlG 1984, BGBl I 1983, 1583), subsequently moved to sec. 26 of the KStG by the DE: KStReformG, BGBl I 1976, 2597, and repealed by the StSenKG, BGBl I 2000, 1433.

58. Secs. 8b(1) and 8b(5) of the KStG, as amended by StSenKG, BGBl I 2000, 1433 and by DE: UntStFG 2001, BGBl I 2001, 3858 (no ownership requirement; deeming 5% of the dividend to be a non-deductible expense).

59. Secs. 46 and 46A Income Tax Assessment Act 1936 (“dividend rebate”). See Weissman, *supra* n. 47, at p. 211 (1960) and J. Azzi, *Historical Development of Australia's International Taxation Rules*, 19 Melb. U. L. Rev., p. 802 (1994).

60. Secs. 160AFB and 160AFC Income Tax Assessment Act 1936 (10% ownership requirement at each tier, 5% Australian ownership of another company in the group). See, for example, Azzi, *supra* n. 59, at pp. 806-807. The indirect credit has been repealed by AU: New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004 No. 96, as all non-portfolio dividends were excluded from assessable income (AU: Income Tax Assessment Act, 1934, sec. 23A).

61. Sec. 23AJ of the Income Tax Assessment Act 1934, as amended by AU: Taxation Laws Amendment (Foreign Income) Act 1990 No. 5 of 1991 (10% voting interest requirement; exemption for non-portfolio dividends paid to an Australian company out of comparably taxed profits) and by the New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004 No. 96 (10% voting ownership requirement; all foreign non-portfolio dividends are exempt).

62. See Hamulyák, *supra* n. 41 and, for more recent development, see F. Snel, *New Rules on Qualifying Subsidiaries under the Dutch Participation Exemption Regime*, 50 Eur. Taxn. 4 (2010), Journals IBFD.

63. LU: *Loi du 4 décembre 1967 concernant l'impôt sur le revenu*, Mem. A No. 79, 1225, art. 166, National Legislation IBFD (25% ownership requirement and requirement of comparable taxation, with 50% exemption), and art. 166 of the *Loi du 4 décembre 1967 concernant l'impôt sur le revenu*, Mem. A No. 79, 1225, as amended by *Loi du 30 novembre 1978*, Mem. A No. 81, 1973 (25% ownership requirement and requirement of comparable taxation, with 100% exemption), subsequently reduced to 10% ownership requirement by *Règlement grand-ducal du 22 avril 1986*, Mem. A No. 35, 1273 and further amended to apply to all 10% holdings in EU companies irrespective of comparable taxation; subsequent amendments have extended art. 166 to cover certain absolute minimum investments (currently, EUR 1.2 million).

64. Sec. 10 of the KStG 1966, BGBl 1966/156, as amended by BGBl 1972/441 (25% ownership requirement, with 100% exemption) and sec. 10 of the KStG 1988, BGBl 1988/401 (25% ownership requirement, subsequently reduced to 10% by AT: Budget Supplementary Act 2003, BGBl I 2003/71, and eventually to 0% by AT: AbgÄG 2011, BGBl I 2011/76, for subsidiaries in countries with which Austria has comprehensive exchange of information).

65. Sec. 240(c) of the Revenue Act of 1918, 40 Stat. 1078.

66. US: SC, 1942, *AmericanChicle Co. v. US*, 316 US 450. See also, for example, US: SC, 1989, *US v. Goodyear Tire & Rubber Co.*, 493 US 132. Compare, Nelson Moore, *supra* n. 17, at p. 209 and Larkins, *supra* n. 21, at p. 241.

67. See, also for example, *US v. Goodyear Tire & Rubber Co.*, 493 US 132 (1989), with references to legislative history.

68. Technically, this equalization generally involves a “gross-up” so that the taxable income of the parent company is the dividend received and the foreign tax deemed paid. see, for example, for the United States, US: Internal Revenue Code (IRC), sec. 78.

69. W. Schön, *International Tax Coordination for a Second-Best World (Part II)*, 2 World Tax J. 1, sec. 4.4.4.2. (2010), Journals IBFD. For a comparative discussion of different ownership percentage requirements for direct investment see Larkins, *supra* n. 21, at p. 223.

not include that the taxation of foreign branches,⁷⁰ even though theoretically consistency, would extend exemption to active business income earned through foreign PEs,⁷¹ as it was clearly considered in recent US discussions.⁷²

While some countries employ territorial systems for historical reasons, over the past few years, other countries have moved from an indirect credit system to an exemption one. Indeed, of the 34 OECD Member countries, 26 now have territorial tax systems, including Australia since 1991,⁷³ Germany since 2001,⁷⁴ and Japan,⁷⁵ New Zealand⁷⁶ and the United Kingdom since 2001.⁷⁷ Only eight countries⁷⁸ still employ worldwide systems.⁷⁹ The recent move to exemption system in Japan, New Zealand and the United Kingdom may, hence, help to complete the picture of possible practical and policy reasons in favour of exemption over indirect credits. In Japan, the facilitation of repatriation of profits was a driving force behind the change to an exemption system in the Tax Reform 2009/10, which was based on the concepts of neutrality regarding corporate decisions on dividend policy, maintaining adequate avoidance of double taxation and simplifying the system.⁸⁰ The United Kingdom put an even stronger focus on global competition and stated that:⁸¹

[t]he case for change rests largely on supporting large and medium business operating in rapidly growing global markets by

simplifying and modernising the current regime for foreign dividends.

Likewise, the change in New Zealand was based on the consideration that:⁸²

[w]ithin 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. The changes introduced by the review of our international tax rules will align them with the rules of comparable jurisdictions and reduce the barriers faced by New Zealand firms that are contemplating expanding offshore.

Along the same lines, Canada's discussion of an extension of the exemption system took into account competitiveness and the international trend, and noting that an indirect credit system and the looming residual taxation discourages repatriation of business profits earned abroad.⁸³ Similarly, in the United States, there have been several proposals in recent years with regard to implementing a more territorial regime, thereby exempting active foreign income earned by a foreign branch or repatriated as a dividend from a foreign subsidiary,⁸⁴ though the opposite position of a full inclusion system has also been proposed.⁸⁵ However, a recent proposal for a "Tax Reform Act of 2011" introduced by the US House Ways and Means Committee foresees a move to a territorial system by repealing the indirect credit and providing a deduction equal to 95% of foreign-source dividends received by a 10% US corporate shareholder from a CFC.⁸⁶

The driving force behind employing a participation exemption regime as opposed to an indirect credit system, therefore, seems to be "competitiveness". In an environment where many countries apply exemption systems, countries that exercise worldwide taxation arguably put their firms at a competitive disadvantage so that a move to territoriality would enhance the competitiveness of such firms in the global economy.⁸⁷ Indeed, it is often noted

70. See for the two-phase approach in the United Kingdom, HM Treasury, *Taxation of foreign profits of companies: a discussion document* (June 2007), and, for the subsequent alignment of the treatment between the taxation of foreign branches and foreign subsidiaries, HM Treasury, *Foreign branch taxation: a discussion document* (27 July 2010) and HM Treasury, *Corporate Tax Reform: delivering a more competitive system* (Nov. 2010).

71. See, for example, Schön, *supra* n. 69 and Lüdicke, *supra* n. 51, at sec. 3.2.3.4.

72. See, for example, The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* p. 33 (Dec. 2010).

73. Sec. 23A] of the Income Tax Assessment Act 1934, as amended by Taxation Laws Amendment (Foreign Income) Act 1990 No. 5 of 1991 (10% voting interest requirement; exemption for non-portfolio dividends paid to an Australian company out of comparably taxed profits), as amended by the New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004 No. 96 (10% voting ownership requirement; all foreign non-portfolio dividends are exempt).

74. Secs. 8b(1) and 8b(5) KStG, as amended by the StSenkG, BGBl I 2000, 1433 and the UntStFG 2001, BGBl I 2001, 3858 (no ownership requirement; deeming 5% of the dividend as non-deductible expense).

75. Art. 23-2 Corporate Tax Act. See Masui, *supra* n. 56.

76. See NZ: Taxation (International Tax, Life Insurance, and Remedial Matters) Act. Compare also, Policy Advice Division of Inland Revenue & New Zealand Treasury, *New Zealand's International Tax Review – Developing an active income exemption for controlled foreign companies* (Oct. 2007) and *New Zealand's International Tax Review – Extending the active income exemption to non-portfolio FIFs* (Mar. 2010).

77. Part 9A Corporation Tax Act 2009 (sch. 14 Finance Act 2009).

78. These are Chile, Greece, Ireland, Israel, Korea (Rep.), Mexico, Poland and the United States. See US Joint Committee on Taxation, *supra* n. 4, at p. 72.

79. For a recent detailed discussions of the various regimes in several countries see the reports in *Trends in company/shareholder taxation: single or double taxation?* *supra* n. 46 and G. Maisto ed., *International and EC Tax Aspects of Groups of Companies* (IBFD 2008), Online Books IBFD.

80. See, with reference to the Japanese Government Tax Commission, Masui, *supra* n. 56, at sec. 2.2. and Miyatake, *supra* n. 56, at secs. 1. and 3.

81. HM Treasury, *Taxation of the foreign profits of companies: a discussion document* para. 1.5 (June 2007). See also HM Treasury, *Corporate Tax Reform: delivering a more competitive system*, *supra* n. 70, at paras. 3.3-3.4 (concerning, inter alia, branch taxation).

82. Policy Advice Division of Inland Revenue & New Zealand Treasury, *New Zealand's International Tax Review – Developing an active income exemption for controlled foreign companies*, *supra* n. 76, at para. 2.3.

83. See, for example, Advisory Panel on Canada's System of International Taxation, *supra* n. 2, at para. 2.15 and, with reference to the Japanese Government Tax Commission, Masui, *supra* n. 56, at sec. 2.2.

84. See, for example, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (27 Jan. 2005); President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005); US Department of the Treasury, *supra* n. 4, at p. 54 et seq.; and National Commission on Fiscal Responsibility and Reform, *supra* n. 72, at pp. 28-35. See also M.J. Graetz & P.W. Oosterhuis, *Structuring an Exemption System for Foreign Income of US Corporations*, 54 Natl. Tax J., p. 771 (2001) and, for a recent discussion see US Joint Committee on Taxation, *supra* n. 4, at p. 80 et seq.

85. See, for example, R.S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 Tax Notes, p. 1775 (29 June 1998) and R.J. Peroni, J.C. Fleming Jr. & S.E. Shay, *Getting Serious About Curtailing Deferral of US Tax on Foreign Source Income*, 52 SMU Law Rev., p. 455 (1999).

86. See the Ways and Means Discussion Draft to amend the Internal Revenue Code of 1986 to provide for comprehensive income tax reform (26 Oct. 2011), available at <http://waysandmeans.house.gov/taxreform/>.

87. See President's Advisory Panel on Federal Tax Reform, *supra* n. 84, at p. 87 and US Department of the Treasury, *supra* n. 4, at p. 54. See also T.R. Chorvat, *Ending the Taxation of Business Income*, 42 Ariz. L. Rev., p. 835 (2000) and K. Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, 79 Tex. L. Rev., pp. 1563-1564 (2001).

that a move to exemption is necessary to bring a system “more in line with our traditional trading partners”,⁸⁸ to be “consistent with recent international developments”⁸⁹ and to ensure that domestic “businesses can compete on an even footing with foreign competitors operating in the same country”.⁹⁰ Moreover, the repatriation of foreign profits to strengthen the home economy has had major effect on policy decisions and is a driving force behind recent moves to territoriality.⁹¹ It is against this background that, in 2004, even the United States introduced a temporary provision to encourage US multinational companies to repatriate foreign earnings by granting a 85% dividends received deduction instead of indirect foreign credits.⁹² This stimulus has led to a repatriation of USD 360 billion in 2004, exceeding the average of the previous years by USD 250 billion, thereby implying that “the magnitude of repatriations is suggestive of the magnitude of the amount of investment dollars subject to potentially distorted economic choices”.⁹³ Indeed, “[a] territorial system would also tend to eliminate one of the principal distortions caused by deferral – the disincentive to repatriate foreign earnings – and facilitate repatriation decisions based on business needs, rather than on tax considerations”.⁹⁴ The intuitive connection between repatriation and economic growth has, however, been empirically challenged. A recent report by a US Senate Subcommittee advises against enacting a second corporate repatriation tax break and notes that the empirical evidence⁹⁵

shows that, rather than producing new jobs or increasing research and development expenditures, the 2004 repatriation tax provision was followed by an increase in dollars spent on stock repurchases and executive compensation. In addition, the repatriation tax break created a competitive disadvantage for domestic businesses that chose not to engage in offshore operations or investments, and provided a windfall for multinationals in a few industries without benefitting the US economy as a whole.

From a practical perspective, exemption is usually tied to certain prerequisites.⁹⁶ These most commonly involve a minimum capital ownership of, or voting rights in, the foreign subsidiary,⁹⁷ which, hence, requires a distinction

88. National Commission on Fiscal Responsibility and Reform, *supra* n. 72, at p. 33.
89. Advisory Panel on Canada’s System of International Taxation, *supra* n. 2, at para. 2.25.
90. Policy Advice Division of Inland Revenue and the Treasury, *New Zealand’s International Tax Review – Extending the active income exemption to non-portfolio FIFs*, *supra* n. 76, at para. 2.4.
91. See, for example, Advisory Panel on Canada’s System of International Taxation, *supra* n. 2, at para. 2.15.
92. See sec. 965 of the IRC, and the discussion by the US Joint Committee on Taxation, *supra* n. 4, at p. 50.
93. US Joint Committee on Taxation, *supra* n. 4, at pp. 76-77.
94. *Id.*, at p. 84.
95. See Permanent Subcommittee on Investigations of the US Senate Committee on Homeland Security and Governmental Affairs, *Repatriating Offshore Funds: 2004 Tax Windfall for Selected Multinationals* p. 3 (11 Oct. 2011).
96. For recent comprehensive information on the various domestic rules see, for example, US Joint Committee on Taxation, *Background and Selected Issues Related to the US International Tax System and Systems that Exempt Foreign Business Income*, JCX-33-11 (20 May 2011) and *supra* n. 4.
97. For instance, 5% in France (FR: *Code Général des Impôts*, art. 145, National Legislation IBFD, CGI) and the Netherlands (NL: *Wet op de vennootschapsbelasting*, art. 13, National Legislation IBFD); 10% in Australia (sec. 23A) Income Tax Assessment Act 1934), Canada (CA: Income

between portfolio investments and direct investments,⁹⁸ minimum holding periods,⁹⁹ and various requirements, such as that the subsidiary must earn active income and is subject to a certain effective tax rate.¹⁰⁰ Another trend is the implementation of countermeasures against international tax arbitrage through hybrid financial instruments, as some countries only apply the exemption method under the condition that the dividends are not tax deductible in the source state.¹⁰¹ Exemption also puts more pressure on expense allocation,¹⁰² transfer pricing rules and limitations or anti-abuse provisions to avoid income shifting, for example, CFC rules.¹⁰³ As HM Treasury pointed out in a policy document before the United Kingdom’s move in 2009 to an exemption system for foreign dividends paid to large and medium UK-based businesses:¹⁰⁴

[a]n exemption regime, however, would need to be coupled with alternative means of protecting UK revenues. So the paper proposes a new income-based system for controlled companies (CC), which would distinguish mobile passive income from active income and enable the UK to tax artificially located profits that are effectively within the control of the UK parent.

From a policy perspective, one final note seems appropriate. Both the neutrality theories and double tax relief in practice seem to be based on the classical assumption “that the economic burden of source-based taxation is not shifted to immobile factors (labor, land, and the like) and

.....
Tax Act, sec. 113(1), National Legislation IBFD) and Luxembourg (art. 166 *Loi du 4 décembre 1967 concernant l’impôt sur le revenu*); and 25% in Japan (art. 23-2 Corporate Tax Act). However, some countries apply their exemptions systems, under certain conditions, irrespective of the size of the holding, such as, for example, Austria (sec. 10 KStG), Germany (sec. 8b(1) KStG), and the United Kingdom (part 9A Corporation Tax Act 2009).

98. For possible theoretical foundations of this distinction see Schön, *supra* n. 69, at sec. 4.4.3.- 4.4.6.
99. For instance, from six months in Japan (art. 23-2 Corporate Tax Act) to two years in France (art. 145 CGI).
100. See, for example, for Austria, sec. 10(4) of the KStG (switch-over to indirect credit if the subsidiary has passive income and is taxed at rate below 15%) and, for Canada, sec. 113(1) of the Income Tax Act (exemption for “active business” earnings of the foreign affiliate earned in a country with which Canada has a tax treaty or, since 2008, a tax information exchange agreement). See also B.J. Arnold, *Critique of the Report of the Advisory Panel on Canada’s International Tax System*, 63 Bull. Intl. Taxn. 8/9, sec. 2. (2009), Journals IBFD.
101. See, for Austria, sec. 10(7) of the KStG (which was introduced by AU: Budgetbegleitgesetz 2011, BGBl I 2010/111); for Denmark, DK: Corporate Tax Act, sec. 13(1), National Legislation IBFD (see also J. Bundgaard, *Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 2*, 50 Eur. Taxn. 11, sec. 4.1.3. (2010), Journals IBFD); and, for Italy, the discussion by the Advisory Panel on Canada’s System of International Taxation, *Taxation of Foreign Source Income in Selected Countries* p. 34 (May 2008).
102. For a comparative analysis see Advisory Panel on Canada’s System of International Taxation, *Tax Treatment of Expenses Attributable to Foreign Source Income in Selected Countries* (May 2008). Some countries, for example, Germany (secs. 8b(1) and 8b(5) of the KStG, as amended by the StSenkG, BGBl I 2000, 1433, and by the UntStFG 2001, BGBl I 2001, 3858) and Japan (art. 23-2 Corporate Tax Act), only exempt 95% of incoming dividends so as to deem a lump-sum amount of non-deductible expenses.
103. For a discussion of potential consequences for the tax system of a move from the indirect credit system to exemption see US Department of the Treasury, *supra* n. 4, at pp. 58-61.
104. HM Treasury, *Taxation of the foreign profits of companies: a discussion document*, *supra* n. 81, at para. 1.6.

is totally borne by mobile factors (capital),¹⁰⁵ or, more directly, that the burden of the corporate income tax economically falls on the shareholders. Indeed, domestic systems of corporate-shareholder integration seem to be based on the assumption that the corporate level tax is an economic “prepayment” by the shareholders. This assumption seems to be even more visible when an indirect tax credit is granted for the underlying foreign corporate tax, which clearly suggests that the foreign tax is considered to fall economically on the domestic parent company, i.e. creating “double taxation”, as no credit, but, rather, a deduction, is given for the other costs of doing business, including indirect taxes.¹⁰⁶ This position is found specifically in older US theoretical literature, where it is noted that “the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax”.¹⁰⁷ Based on the assumption that US corporate and individual income taxes are borne by the taxpayers on whom they are imposed, the same conclusion could pertain to foreign income taxes as well.¹⁰⁸ These assumptions about the incidence of the corporate tax are, however, challenged for situations of open economies. Indeed, spurred on by the analysis of Harberger (1962),¹⁰⁹ economists and lawyers have long struggled with the question of where the short-term and long-term economic burden of the corporate income tax falls as between shareholders, holders of capital in general, employees, consumers or suppliers.¹¹⁰ While it was initially concluded that, in the long term, all capital, and not just corporate capital, bore the economic burden of corporate income taxation in a closed economy,¹¹¹ further arguments have evolved due to the globalization of capital markets. Indeed, the popular view among economists is that, due to the tax effect on capital stock and labour-capital substitution, at least a (large) portion of the burden of the corporate tax economically falls on labour,¹¹² although

others maintain that capital and specifically shareholders bear the main share of the burden in the short and even long run.¹¹³ However, as the traditional and implicit reason specifically for indirectly crediting foreign corporate taxes is probably no longer convincing, it has been implied that, if foreign taxes were indeed substantially shifted, “the provision of the foreign tax credit is a wind-fall the elimination of which should be considered”.¹¹⁴

5. International Perspectives: the OECD and the European Union

Unlike the US Model (2006),¹¹⁵ neither the OECD Model (2010) nor the UN Model (2001)¹¹⁶ deal with the economic double taxation of dividends. Articles 10 and 23 of the OECD Model (2010) effectively avoid the juridical double taxation of dividends, but they do not prevent recurrent corporate taxation on the profits distributed to the parent company, i.e. first at the level of the subsidiary and again at the level of the parent company. Specifically, the Commentary on Article 5 of the OECD Model (2010) states that juridical double taxation, which is dealt with by article 23:¹¹⁷

has to be distinguished especially from the so-called economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

However, as the Commentary on Article 23 of the OECD Model (2010), and by way of reference also the Commentary on Article 23 of the UN Model (2001),¹¹⁸ notes:¹¹⁹

[s]uch recurrent taxation creates a very important obstacle to the development of international investment. Many States have recognised this and have inserted in their domestic laws provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions.

105. See, for example, Shadeen, *International Tax Neutrality: Revisited*, *supra* n. 16, at pp. 133 and 144-147.

106. For a critical discussion of this assumption see Nelson Moore, *supra* n. 17, at pp. 212-224.

107. E.A. Owens, *The Foreign Tax Credit* p. 83 (Cambridge 1961). See also S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 Colum. L. Rev., p. 821 (1956).

108. Owens, *supra* n. 107, at pp. 84-85.

109. A.C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. Political Econ., p. 215 (1962).

110. For a recent summary of the issues see OECD, *Fundamental Reform of Corporate Income Tax*, Tax Policy Studies No. 16 pp. 72-75 (2007). See for this discussion also, for example, W.A. Klein, *The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics*, Wisconsin L. Rev., pp. 581-87 (1965); Nelson Moore, *supra* n. 17, at pp. 219-224 (1988); A.J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know*, 20 Tax Policy & the Econ. 1, p.1 (2006); and W.M. Gentry, *A Review of the Evidence of the Incidence of the Corporate Income Tax* (Department of the Treasury, OTA Paper 101 2007).

111. Harberger, *supra* n. 109.

112. Indeed, Harberger supported this view himself in later years; see A.C. Harberger, *The ABCs of Corporate Tax Incidence: Insights into the Open Economy Case*, in American Council for Capital Formation, *Tax Policy and Economic Growth* (Washington, D.C. 1995). For recent empirical studies, see R. Alison Felix, *Passing the Burden: Corporate Tax Incidence in Open Economies*, Working Paper Federal Reserve Bank of Kansas City (Oct. 2007) (a 10% increase in the corporate tax rate reduces annual gross wages by 7%); M.A. Desai, C. Fritz Foley & J.R. Hines Jr., *Labor and Capital Shares of the Corporate Tax Burden: International Evidence*, Working Paper, Harvard U. (Dec. 2007) (local labour bears between

45% to 75% of the corporate tax burden); W.C. Randolph, *International Burdens of the Corporate Income Tax*, Congressional Budget Office Working Paper No. 2006-09 (2006 (73% of the US corporate income tax burden is borne by labour); and W. Arulampalam, M.P. Devereux & G. Maffini, *The Direct Incidence of Corporate Income Tax on Wages*, Oxford U. Working Paper 07/07 (May 2008) (USD 1 of additional corporate tax reduces wages by 92 cents in the long run).

113. See J.G. Gravelle & K.A. Smetters, *Does the Open Economy Assumption Really Mean that Labor Bears the Burden on a Capital Income Tax*, 6 Advances in Econ. Analysis & Policy, Article 3 (2006) and Auerbach, *supra* n. 110, at p. 33.

114. K. Nelson Moore, *supra* n. 17, at pp. 225-226.

115. *US Model Tax Convention on Income*, art. 23(2)(b) (15 Nov. 2006), Models IBFD provides for a deemed-paid credit, consistent with sec. 902 of the IRC, to be made available to a US corporation in respect of dividends received from a corporation resident in the other contracting state of which the US corporation owns at least 10% of the voting stock. This credit is for the tax paid by the corporation to the other contracting state on the profits out of which the dividends are considered paid.

116. *UN Model Tax Convention on Income and on Capital* (1 Jan. 2001), Models IBFD.

117. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23*, para. 2 (22 July 2010), Models IBFD. See also the Final Report of Working Party 15, FC/WP15(60)2 (28 Sept. 1960) 4 and *Commentary on Articles XXIII and XXIV* para. 2 (*Special credit with respect to dividends of The Fourth Report of the Fiscal Committee on The elimination of double taxation*, C(61)97 (OECD, 1961).

118. Para. 14 *UN Model: Commentary on Article 23* (2001).

119. Para. 50 *OECD Model: Commentary on Article 23* (2010).

The deliberations leading to the OECD Model (1963)¹²⁰ did not deal with this issue either.¹²¹ The Commentary on Article 23 of the OECD Model (1963) merely addressed a concern by the UK delegation¹²² with regard to the continuing permissibility of indirect credits in light of article 23, and noted that:¹²³

[c]ertain States wishing to apply the credit method allow in their Conventions, in respect of dividends received from companies in other States, credit, not only for the amount of tax directly levied on the dividends in those other States, but also for that part of the companies' tax which is appropriate to the dividends. Member States applying this method are left free to do so.

The Commentary on Article 23 of the OECD Model (2010)¹²⁴ addresses this issue and notes that, while it has been discussed by the Committee on Fiscal Affairs to modify article 23 of the OECD Model (2010) to settle this question and, even though many states favoured such amendment, no consensus could be reached so that:¹²⁵

[i]n the end, it appeared preferable to leave States free to choose their own solution to the problem. For States preferring to solve the problem in their conventions, the solutions would most frequently follow one of the principles below:

120. *OECD Model Tax Convention on Income and on Capital* (30 July 1963), Models IBFD.

121. In the preparation of the *OECD Model* (1963), neither Working Party No. 12 (on the taxation of dividends) nor Working Party No. 15 (on the methods to avoid double taxation) dealt with this issue. Working Party No. 15 of the Fiscal Committee noted in its Report on *Methods for the Avoidance of Double Taxation*, FC/WP15(59)1 Part I, p. 2 (2 Mar. 1959) that "[t]he Working Party wish to point [the limitation of its study to juridical double taxation] out as the question of the avoidance of so-called economic double taxation (i.e., a taxation of the same income in the hands of two different persons both chargeable to tax) is one which the Fiscal Committee may wish to consider later. For the present, however, the question of the methods to be used in relation to this kind of double taxation has not been studied by the Working Party." The Working Party, however, pointed out that "provisions for the solution of this question are not unknown in some of the Conventions concluded between Member States of the OEEC", and noted, inter alia, that "[t]he Convention between Sweden and Denmark contains, for example, a provision aiming at the avoidance of, or the limitation of, the economic double taxation existing in the case where profits are passed on, by way of a dividend, to a parent company in one State from its subsidiary company in the other State". Likewise, Working Party No. 12 of the Fiscal Committee mentioned in its *Report on the Taxation of Dividends*, FC/WP12(58)1 Part I, pp. 2-3 (23 Nov. 1958) that it will not deal with economic double taxation of distributed profits, "as the report deals with the taxation of dividends as income of the shareholder".

122. See the Minutes of the 15th Session of the Fiscal Committee, FC/M(59)5 (30 Dec. 1959) 5, where the Delegate for the United Kingdom "explained how the credit for underlying tax method operated; it allowed relief to be given in cases of economic double taxation, by taking into account not only the amount of tax levied directly on dividends paid by a company but also the tax levied in the company's profits out of which the dividends were paid. He thought the Committee should allow countries applying this method to continue to do so, since it was in the taxpayer's interest." The Minutes then state that "[t]he Chairman suggested that it should be made clear in the Commentary that countries wishing to do so could apply the procedure adopted in the United Kingdom, and that Working Party No. 15 should study the problems raised by economic double taxation".

123. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23* para. 52 (30 July 1963), Models IBFD. See already, with the same wording, the Final Report of Working Party 15, FC/WP15(60)2 (28 Sept. 1960) 19-20 (*Special credit with respect to dividends*) and para. 52 of the *Commentary on Arts. XXIII and XXIV (Special credit with respect to dividends)* of The Fourth Report of the Fiscal Committee on *The elimination of double taxation*, C(61)97 (OECD, 1961).

124. Para. 49-54 *OECD Model: Commentary on Article 23* (2010) (unchanged from *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23* (11 Apr. 1977), Models IBFD).

125. Para. 52 *OECD Model: Commentary on Article 23* (2010).

a) *Exemption with progression*

The State of which the parent company is a resident exempts the dividends it receives from its subsidiary in the other State, but it may nevertheless take these dividends into account in computing the tax due by the parent company on the remaining income (such a provision will frequently be favoured by States applying the exemption method specified in Article 23 A).

b) *Credit for underlying taxes*

As regards dividends received from the subsidiary, the State of which the parent company is a resident gives credit as provided for in paragraph 2 of Article 23 A or in paragraph 1 of Article 23 B, as appropriate, not only for the tax on dividends as such, but also for the tax paid by the subsidiary on the profits distributed (such a provision will frequently be favoured by States applying as a general rule the credit method specified in Article 23 B).

c) *Assimilation to a holding in a domestic company*

The dividends that the parent company derives from a foreign subsidiary are treated, in the State of the parent company, in the same way for tax purposes as dividends received from a subsidiary which is a resident of that State.

The Commentary on Article 23 of the OECD Model (2010) also makes reference to typical limitations of exemptions systems and notes that:¹²⁶

... States are free to fix the limits and methods of application of these provisions (definition and minimum duration of holding of the shares, proportion of the dividends deemed to be taken up by administrative or financial expenses) or to make the relief granted under the special regime subject to the condition that the subsidiary is carrying out a genuine economic activity in the State of which it is a resident, or that it derives the major part of its income from that State or that it is subject to a substantial taxation on profits therein.

The issue of the exemption method for dividends in respect of substantial holdings was again raised in the OECD's Report on Harmful Tax Competition, where it was not only recommended to consider the implementation or strengthening of CFC legislation, but also that countries that apply participation exemption or other systems of exempting foreign income should consider adopting rules that would ensure that foreign income that had benefited from tax practices deemed as constituting harmful tax competition do not qualify for the application of the exemption method.¹²⁷ More specifically, the Report stated:¹²⁸

104. Most, if not all, exemption countries have certain limitations applicable to their exemption system. These measures include, for example, restricting the exemption to active business income and taxing passive income regardless of its source.

105. On the basis of restrictions that already exist in the legislation of Member countries, possible 'minimum' restrictions could be designed on the basis of:

- *the countries from which the foreign income originates*: for example, it could be decided that income originating from a country that is included in a list of tax havens or from listed harmful preferential tax regimes should not be granted exemption;

126. Para. 54 *OECD Model: Commentary on Article 23* (2010).

127. OECD, *Report on Harmful Tax Competition – An Emerging Global Issue*, para. 97 et seq. (1998).

128. *Id.*, at paras. 104-105.

- *the type of income*: foreign income that clearly could be attributed to practices constituting harmful preferential tax regimes would not be entitled to exemption;
- *the effective rate of tax to which the income has been subjected*: restrictions based on a minimum rate of foreign tax effectively paid are often found in participation exemption systems. They should, however, be linked to the other aspects of harmful preferential tax regimes as set out in [the chapter relating to factors to identify tax havens and harmful preferential tax regimes].

The OECD's considerations in the Report of Harmful Tax Competition seem to be mirrored by recent policy debates in the European Union. Let us first consider current law. As is well known, neither the Parent-Subsidiary Directive (1990) nor the ECJ spell out a preference for either exemption or indirect credit and treat both methods as, more or less, equal.¹²⁹ Under article 4 of the Parent-Subsidiary Directive, Member States have the choice to relieve economic double taxation of cross-border intercompany dividends by either exempting the distribution at the level of the parent company or by giving an indirect credit for taxes levied on the level of the subsidiary and lower-tier companies. While the Commission's initial 1969 proposal only contained the exemption method as a consensus of the then six Member States,¹³⁰ the credit method was added without much discussion after Denmark, Ireland and the United Kingdom, all having been credit countries, had joined the European Community.¹³¹ Neither of the two methods is tied to prerequisites other than a minimum holding percentage (article 3(1)) and, optionally, a holding period of two years (article 3(2)), and Member States are, hence, barred from introducing additional requirements, such as, for example, that a shareholding must be considered as a "fixed financial asset",¹³² the existence of a tax treaty,¹³³ or a certain level of taxation of the subsidiary's income.¹³⁴ As for the last point, technically, article 2 of the Directive, inter alia, requires that a company has to be subject to one of the taxes listed in article 2(1)(c) "without the possibility of an option or of being exempt", a condition whose interpretation is heavily discussed and may perhaps only

exclude companies that are fully exempt from taxation.¹³⁵ Under the current regime, Member States are free to choose between both methods,¹³⁶ and may do so in applying different methods in respect of different Member States, for example, based on a tax treaty, or towards one and the same Member State based on, for example, the level of taxation or the type of income earned by the subsidiary.¹³⁷ Such different treatment of different cross-border situations is also permissible under the fundamental freedoms.¹³⁸ Moreover, under the fundamental freedoms, Member States may in principle employ the exemption method for domestic intercompany dividends and the indirect credit method for cross-border intercompany dividends.¹³⁹

However, things are apparently moving. Following the Commission's recent proposal for a recast of the Parent-Subsidiary Directive,¹⁴⁰ the European Parliament's Committee on Economic and Monetary Affairs issued critical comments and urged stronger anti-abuse provisions to be integrated into the Directive.¹⁴¹ A more recent European Parliament document,¹⁴² however, called for concrete amendments to the Directive, inter alia, in respect of the inclusion of a compulsory two-year holding period, an increase in the ownership requirement from 10% to 15%, an option for Member States to require capital ownership and voting rights,¹⁴³ and an amendment to the relief

129. However, the majority of scholars consider the exemption method as being more in line with the Internal Market. See G. Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* pp. 625-626 (Linde 2007), with further references.

130. See art. 4 of the Commission's Proposal concerning the common system of taxation applicable in the case of parent corporations and subsidiaries of different Member States, COM(69)6 final, with an unofficial English translation in *Proposed Directive concerning a Common System of Taxation applicable to Merger-Type and Parent-Subsidiary Relationships between Corporations of Different Member States*, 9 Eur. Taxn. 7 (July 1969), Journals IBFD.

131. The deliberations on this issue are found in Council documents Doc. R/129/74 FIN 38 (23 Jan. 1974) 2, Doc. 6048/84 FISC 27 (28 Mar. 1984) 5 (Appendix II) and Doc. 6446/84 FISC 42 (18 Apr. 1984) 3. For a review of the historical development of art. 4 of the Directive, see G. Kofler, *Mutter-Tochter-Richtlinie*, art. 4 m.nos. 9-19 (LexisNexis 2011).

132. See European Commission Press Release IP/09/1770 (20 Nov. 2009) concerning an infringement proceeding against Belgium on that issue (the proceeding was closed on 29 September 2011 following a change in Belgian legislation).

133. R. H. Boon & M. V. Lambooj, *EC Parent-Subsidiary Directive: Steps Towards Harmonization of Direct Taxes*, 18 Tax Planning Intl. Rev. 4, p. 8 (Apr. 1991).

134. Kofler, *supra* n. 129, at art. 2 m.no. 35 and art. 3 m.nos. 2.

135. For an extensive discussion, see Kofler, *supra* n. 129., at art. 2 m.nos. 30-36. See also *Aberdeen Property* (C-303/07), at para. 27 (concerning a Luxembourg SICAV).

136. UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, paras. 43-44, ECJ Case Law IBFD; BE: ECJ, 12 Feb. 2009, Case C-138/07, *Belgian State v. Cobelfret NV*, para. 31, ECJ Case Law IBFD; and BE: ECJ, Order, 4 June 2009, Case C-439/07, *Belgian State v. KBC Bank NV*, paras. 43 and 47, ECJ Case Law IBFD.

137. See Kofler, *supra* n. 129, at art. 4 m.no. 6 with further references.

138. *Test Claimants in the FII Group Litigation* (C-446/04) and DE: ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt*, ECJ Case Law IBFD.

139. *Test Claimants in the FII Group Litigation* (C-446/04); AT: ECJ, 10 Feb. 2011, Joined Cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH, Österreichische Salinen AG v. Finanzamt Linz*, ECJ Case Law IBFD. However, the limits of this equality in light of the freedoms will probably be tested in pending UK: ECJ, Case C-35/11, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, Commissioners for Her Majesty's Revenue & Customs* (the preliminary questions are reprinted in OJ C 103 (2011), p. 15), which was referred to the ECJ after the decision by UK: CA, 23 Feb. 2010, *Test Claimants in the FII Group Litigation v. HM Revenue & Customs* [2010] EWCA Civ 103, paras. 43, 269 and Annex 3. For an earlier discussion, see T. Bieber, W. Haslehner, G. Kofler & C.P. Schindler, *Taxation of Cross-Border Portfolio Dividends in Austria: The Austrian Supreme Administrative Court Interprets EC Law*, 48 Eur. Taxn. 11 (2008), Journals IBFD, and, for a recent analysis of the Austrian legislation at issue in *Haribo and Salinen* (C-436/08 and C-437/08) and the consequences to be drawn from the ECJ's decision in that case, see G. Kofler & B. Prechtl-Aigner, *Beteiligungsertragsbefreiung nach Haribo und Salinen*, 9 Zeitschrift für Gesellschaftsrecht und angrenzendes Steuerrecht 4, pp. 175-197 (2011).

140. European Commission, Proposal for a Council Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), COM(2010)784 final.

141. Draft Report on the proposal for a Council directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), PE462.544, 2010/0387(CNS) (4 May 2011) (Rapporteur: Sven Giegold).

142. PE465.004 (29 June 2011).

143. These criteria are mutually exclusive under the current text of the Parent-Subsidiary Directive (1990). see Kofler, *supra* n. 129, at art. 3 m.no. 101 and European Commission, Report on the Interest-Royalties-Directive in COM(2009)179 final, 8.

clauses of article 4. Of these, only the latter also found its way into a Legislative Resolution,¹⁴⁴ in which the European Parliament recommends that exemption is to be granted if the distributed profits:

have been taxed in the country of the subsidiary at a statutory corporate tax rate not lower than 70% of the average statutory corporate tax rate applicable in the Member States.

And, if a Member State chooses the indirect credit method, it is supposed to tax the incoming distributions:

at a statutory corporate tax rate not lower than 70% of the average statutory corporate tax rate applicable in the Member States.

The European Parliament's intention seems to be clear. At least one significant company-level tax shall be levied in the European Union. However, the suggested clauses would only enable the Member States to include more rigorous conditions for relief into their domestic systems, but would by no means force them to do so. Indeed, if the Member States would like to compensate for foreign low taxation, they could already under current law choose the indirect credit method as foreseen in article 4 of the Parent-Subsidiary Directive.¹⁴⁵ Conversely, however, it is clear that the Directive, and also considering the amendments suggested by the European Parliament, only sets minimum standards, and that the Member States are, in any event, free to provide more generous treatment than that demanded by the Directive.¹⁴⁶ Hence, a complete redraft of the Directive would be required if the Member States were to be compelled to provide relief only in the situations and ways envisaged by the European Parliament. Commissioner Šemeta, while rejecting the European Parliament's approach for various other reasons,¹⁴⁷ has announced that he plans to table an initiative addressing these issues in 2012 "outlining possible approaches to tackle tax circumvention, in particular in case of double non taxation".¹⁴⁸

144. See European Parliament legislative resolution of 26 October 2011 on the proposal for a Council directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast), T7-0464/2011.

145. See F. Vanistendael, *Tax Policy Reform: The Implementation of the Parent/Subsidiary Directive in the EC – Comments on some Unresolved Questions*, 5 Tax Notes Intl., p. 603 (21 Sept. 1992); P. Farmer & R. Lyal, *European Tax Law* p. 265 (Clarendon Press 1994); and Kofler, *supra* n. 129, at art. 2 m.no. 33.

146. See, for example, Kofler, *supra* n. 129, at Einl m.no. 46, art. 2 m.no. 2 and art. 3 m.no. 3, with further references.

147. See Algirdas Šemeta EU Commissioner for Taxation and Customs Union, Audit and Anti-Fraud Reaching a level playing field for taxation across Europe Debate on Taxation in European Parliament Plenary Strasbourg, 25 October 2011, SPEECH/11/709 (25 Oct. 2011). In his speech before the European Parliament, Commissioner Algirdas Šemeta pointed out that the European Parliament's approach "would result in the exclusion from the directive scope of companies established in several Member States with rates below the threshold [e.g. Germany, Latvia, Lithuania, Bulgaria, Romania, Ireland and Cyprus]", "would lead to a partial integration of the national markets and a situation potentially challenging the Treaty freedom of establishment", would "have to follow the procedure for amending a Directive", which "requires a much more detailed political and technical assessment than the recast", and that, while he understands "the concern about aggressive tax planning", "the approach contained in the report does not ensure a level playing field, is not sufficiently targeted towards abusive practices and thus not appropriate in this case".

148. *Id.*

Finally, a brief glance at the Commission's Proposal for the Common Consolidated Corporate Tax Base (CCCTB)¹⁴⁹ seems warranted, as it includes a participation exemption that is more favourable than the Parent-Subsidiary Directive (1999) and, hence, stands in stark contrast to the European Parliament's suggestions, and, additionally, in that neither the switch-over clause nor the CFC rule of the CCCTB Proposal would apply to distributions from EU companies. First, the CCCTB Proposal takes a clear stance for the exemption method (with progression) with regard to intercompany dividends from EU and non-EU subsidiaries outside the group (articles 11(c) and 72 of the Proposal), which was, inter alia, chosen for reasons of simplicity.¹⁵⁰ No further conditions, such as an ownership requirement or a minimum holding period, are set.¹⁵¹ However, with regard to subsidiaries in non-EU Member States, i.e. "third countries", the Proposal foresees a switch-over clause (article 73) and a CFC rule (article 82). A switch-over from exemption to full taxation, with only a direct credit for withholding taxes (article 76),¹⁵² would take place if the foreign subsidiary's profits were either taxed at a statutory rate lower than 40% of the EU average, i.e. less than approximately 9.8%,¹⁵³ or subject to a special low-tax regime, irrespective of whether active or passive income is earned. The Commission has described the purpose of this provision as follows:¹⁵⁴

The CCCTB rules provide for the tax exemption of profit distributions (i.e. both portfolio dividends and direct investment) and proceeds from share disposals flowing into the group as well as for income earned from a PE located in a third country. To protect the common tax base from erosion, the system accommodates a switch-over mechanism designed to act as a "gatekeeper", which is meant to discourage the inflow of revenues through low-tax countries. This is achieved by making inflows of otherwise exempt third-country income subject to tax. In certain circumstances, relief by credit is given for tax which has already been paid in the country of source but this does not include credit for the underlying tax. If the distributed profit and/or the proceeds of a share disposal are linked to an entity which has already been taxed by the group as a CFC, the relevant amounts will effectively continue to benefit from the tax exemption in order to avoid double taxation (i.e. once as a CFC; once on a dividend distribution or disposal of shares).

149. European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011)121/4. For first analyses of the Proposal see, for example, *Special Edition*, 4 Highlights & Insights on Eur. Tax. 6, p. 6 et seq. (2011) and L. Cerioni, *The Commission's Proposal for a CCCTB Directive: Analysis and Comment*, 65 Bull. Intl. Taxn. 9 (2011), Journals IBFD.

150. Preamble to the Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, *supra* n. 149, at para. 11.

151. See also Cerioni, *supra* n. 149, at sec. 4.1. This deviates from the position taken by Commission Services, Working Paper CCCTB/WP/057, where it was suggested to model the "participation exemption conditions ... on those in the parent subsidiary directive" (at para. 124) and that a relevant "shareholding should be one where the recipient taxpayer has an interest in of at least 10% of either capital or voting rights and the shareholding or participation is held for an uninterrupted period of at least 12 months" (at para. 125).

152. See M. Vogel, 4 Highlights & Insights on Eur. Taxn. 6, p. 49 (2011).

153. This number was used by experts from the Commission in public presentations of the CCCTB proposal in April 2011. For a discussion of theoretical problems surrounding the establishment of the EU average statutory corporate tax rate, see Cerioni, *supra* n. 149, at sec. 4.1. and 4.2.

154. European Commission, Anti-Abuse Rules in the CCCTB, CCCTB/RD/004 para. 15 (30 Aug. 2010).

The CFC rule in article 82 of the CCCTB Proposal would come into play logically before a distribution that would be subject to switch-over is made, and its application requires, in addition to low taxation, 50% ownership or rights to profits, that 30% of the income consists of specifically listed “tainted income”, and that the entity’s principal class of shares is not regularly traded on one or more recognized stock exchanges. However, an escape clause in articles 82(2) provides that the CFC rule would not apply where the third country is an European Economic Area Member State with which “there is an agreement on the exchange of information comparable to the exchange of information on request provided for in Directive 2011/16/EU”, i.e. the directive on the exchange of information.¹⁵⁵

6. Conclusions

There is an international trend towards exempting profits distributed by foreign subsidiaries at the level of the parent company, with the main reasons for this trend being an increase in the competitiveness of domestic tax systems, simplicity and consistency with recent international developments. Currently, 26 out of the 34 OECD Member countries have territorial tax systems, and alone in 2009 Japan, New Zealand and the United Kingdom have moved towards exemption. Exemption, however simpler it may theoretically be, needs a number of backstops to protect the domestic tax base and in a large part raises the same issues as the indirect credit method. Indeed, as HM Treasury had noted:¹⁵⁶

[t]he case for an exemption system is not clear-cut, however, as the benefits in terms of simplification and savings in administrative costs which exemption brings have to be weighed against the need for an exemption system to be accompanied by more effective controlled company rules and targeted interest changes, in order to prevent the artificial

location of profits which could then be repatriated as exempt dividend income.

It is against this background that the OECD’s Report on Harmful Tax Competition had urged Member States to rethink the application of the participation exemptions to income that had benefited from harmful tax practices. Likewise, the European Parliament has suggested ideas to strengthen the Parent-Subsidiary Directive (1990) in a way to ensure one effective level of company tax to be levied in the European Union. In stark contrast to that, the Commission’s proposal for a CCCTB foresees unconditional exemption for distributions coming from companies outside the group, with the switch-over clause and a CFC rule only applying to distributions from subsidiaries that are resident outside the European Union.

However, the economic effect of either system is not fully understood. First, it is an unsolved puzzle as to whether capital really bears the burden of corporate tax, so that it might even be doubtful whether relief at the shareholder’s level could be soundly based on the assumption that the economic incidence of the tax is on their investment. Second, neither the economic theories on neutrality nor empirical evidence, for example, with regard to tax-hurdles for profit repatriations, make a clear case for either exemption or indirect credit. Indeed, the general conclusion that, with regard to the choice between credit and exemption, neither side has adopted either for reasons of economic neutrality also seems to hold true in respect of relief from economic double taxation of intercompany profit distributions.

155. Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L64 (2011), EU Law IBFD.

156. HM Treasury, *Taxation of the foreign profits of companies: a discussion document*, *supra* n. 81, at para. 1.6.