PROPOSED DIRECTIVE

CONCERNING THE COMMON SYSTEM OF TAXATION APPLICABLE IN THE CASE OF PARENT CORPORATIONS AND SUBSIDIARIES OF DIFFERENT MEMBER STATES

(Submitted by the Commission to the Council)

(Brussels, January 15, 1969, COM (69) 6 final)

Unofficial translation by the International Bureau of Fiscal Documentation, based on the official text in French

EXPLANATORY MEMORANDUM

I. GENERAL

1. With a view to the proper functioning of the Community, its development, and the requirements of growing international competition, it is necessary to enable enterprises of the Community to attain a size which will permit them to meet the demands of an enlarged market, and to improve the competitive strength of such enterprises on a world-wide scale.

The acquisition of participations resulting in the formation of groups of associated corporations in which a parent corporation controls its subsidiaries, constitutes at the present time one of the few feasible types of concentration on the international plane. It is for this reason that resort is frequently had to such operations.

2. The acquisition of a participation by a corporation in the capital of another corporation is simple from the legal point of view and does not generally raise any tax problems at the moment at which it takes place; this is not, however, subsequently the case. Indeed it happens, especially in international relations, that profits which have already been taxed in the hands of a subsidiary are, upon distribution to the parent corporation, once more subjected to tax in the hands of the latter. The economic double taxation which results therefrom constitutes a fundamental obstacle to this form of concentration.

3. On a number of previous occasions, attention has been drawn, at meetings of the organs of the Communities, to the tax problems attendant upon the concentration of corporations of different Member States; such questions were first considered by the Commission in its programme for the harmonization of direct taxes, which was submitted to the Council on June 26, 1967.[1] This Document was studied for several months by the group of financial experts of the Council and was the subject-matter of a report by the Committee of Permanent Representatives.[2] Finally in the course of its meeting of March 4 and 5, 1968 the Council entrusted to the Commission the task of seeking and of proposing solutions to these problems.[3]

4. In its search for such solutions, the Commission first examined whether it was appropriate to extend to all relations between Member States the various domestic systems used for the avoidance of economic double taxation between corporations. This idea might well seem of particular interest especially since certain of these systems already operate on a transnational level by virtue of domestic legislation or of double taxation conventions.

However the Commission rejected this idea. In the first place such a system does not exist in Italy, except in extremely limited cases. Furthermore, the application of domestic systems at the international level, when it does occur, is often incomplete, since double taxation is not generally entirely avoided. Moreover, taking into account differences existing on the one hand between domestic laws and on the other hand between the provisions of the various conventions, such a solution would have resulted in the tax burden imposed on a dividend distributed by a subsidiary to its parent corporation, varying according to the source of such dividend. Such a solution might well have an adverse effect on the movement of capital invested in the form of participations and thus lead to distortions since corporations might be tempted, for tax reasons, to acquire participations in corporations of one country rather than of another country.

The Commission thus considers that a single common system applied by the six States constitutes the only satisfactory solution. But this requires a certain degree of legislative harmonization. It is for this reason that the Commission proposes to the Council that such a system should be established by way of directive.

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1) Cf. doc. R/950/67 (ECO 104).

2) Cf. doc. R/319/68 (ECO 20).

3) Cf. doc. R/111/68.

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5. Three fundamental considerations lie behind the proposed common system.

a) It is above all necessary to avoid economic double taxation and thus to exempt profits which a parent corporation receives from its subsidiaries, from corporation tax in its hands.

b) It is also appropriate to resolve the problem caused by the withholding tax on dividends. In general two techniques are employed by the various countries at the domestic level in order to impose such withholding tax no more than once: the first technique consists of not imposing any withholding tax at the subsidiary level but of imposing such tax at the time when the dividend is redistributed by the parent corporation; the second technique is the converse of the first. While these two methods produce the same result if the dividend is redistributed by the parent corporation, this is not so if it is placed in reserve: in the first case the parent corporation may keep the full amount, while in the second case such amount is permanently reduced by the withholding tax. The imposition of a withholding tax at the subsidiary level thus acts to the detriment of parent corporations whose own business activities do not produce sufficient profits to enable them to finance themselves. On the other hand, the other method, i.e. where there is an exemption at the subsidiary level, avoids this disadvantage by achieving absolute fiscal neutrality with regard to the allocation by the parent corporation of dividends received from its subsidiaries: such parent corporation is in all cases treated as if it had realized such profit directly and not through its subsidiaries.

At the international level withholding taxes are at present almost universally imposed in cases where subsidiaries make distributions to their parent corporations. Such withholding results in double taxation where under its domestic law the State of the parent corporation applies the exemption method at the subsidiary level, i.e. it imposes a new withholding tax when the parent corporation redistributes the dividends. The initial withholding tax thus constitutes a definite tax burden.

The Commission therefore considers it essential that, except in certain particular cases, the method which should be adopted, is that of the exemption from withholding taxes at the subsidiary level. This solution is all the more justified since the withholding tax is normally only an advance payment of tax, and there is no need to require such an advance payment where the recipient of the income is exempted from tax on such income.

c) Finally it is necessary to provide for the possibility for parent corporations holding very substantial participations to be able to opt for the system of consolidated profits. This system consists of including in the profits and losses of the parent corporation the profits and losses of its subsidiaries in proportion to the capital held by it, whilst taking into account the fact that the profits which are thus consolidated have already been taxed at the subsidiary level. Such a system allows for the aggregation of profits and losses in the hands of different taxpayers and thus offers a parent corporation the great advantage of being able to deduct from its taxable profits any losses incurred by its subsidiaries. Such losses are frequent during the first years of operation; they are in fact even usual in certain sectors, such as searching for oil, in respect of which this system offers a particular interest.

The system of consolidated profits tends to substitute for the narrow legal concept of taxpayer, a wider economic concept, that of the "group of corporations" each of which is a separate legal person but which together form an economic unit which is considered as a single taxpayer. It tends to facilitate the concentration of enterprises in the form of very substantial participations and it fits in with the desired evolution, from the economic point of view, of the tax systems of the Member States. Moreover it is the logical complement, as far as parent corporations and subsidiaries are concerned, of the system of world-wide profits which was proposed by the Commission with regard to corporations having foreign permanent establishments that are not endowed with legal personality.

II. EXPLANATORY NOTES WITH REGARD TO CERTAIN PROVISIONS OF THE COMMON SYSTEM

Article 2

The object of this article is to determine which corporations will be able in the relevant circumstances to benefit from the common system. These are all corporations and associations subject to a corporation tax, i.e. in practice all those for which such a system could be of any interest.

Article 3

This article defines in the first place the concept of parent corporation and subsidiary. Obviously this definition relates specifically to the object of the directive, i.e. only for the purposes of the application of the proposed tax provisions, and as such it is without prejudice to the common definitions which will have to be found in commercial law, particularly with regard to the rules governing groups of corporations.

In this respect the following two problems arise:
- in the first place, the determination of a minimum amount of a qualifying participation
- secondly, the period during which such participation must be held.

As regards the first question, existing differences between the various tax systems presently in force are important. Belgium applies the "non bis in idem" principle, with the result that any Belgian corporation holding even one share in another corporation is treated as a parent corporation for tax purposes. On the other hand, Germany, Luxembourg and the Netherlands re-

quire a 25% participation, while France adopts an intermediary position and requires (subject to certain special exceptions) a 10% participation or an acquisition price of at least 10 million francs. The question as to whether economic double taxation ought only to be avoided in cases where there is a substantial participation is arguable;

– against this argument are the standards of tax equality according to which the avoidance of double taxation at a certain level only is open to criticism;

– on the other hand reasons of economic policy favour this argument since by definition concentration presupposes a substantial participation.

The Commission did not wish to decide between these two approaches by requiring certain States to act rather more liberally, and other States to give up their particularly favourable systems. It proposes simply that in relations between subsidiaries and parent corporations of different Member States, the tax concessions in question should apply at least in the case of participations of 20% and more. But it does not exclude the more liberal rules. Such a minimum is however not required where the participation is the consequence of a contribution of assets. Such a contribution would in fact lose a large part of its interest, if economic double taxation were not subsequently avoided.

The second question, i.e. the period during which such a participation must be held, is at present also subject to different treatment by the various States. Certain legal systems are very flexible, while, on the contrary, others are rather stricter in order to avoid a situation where the privileged treatment might be abused through the quick resale of the shares of subsidiaries which have been acquired or subscribed. It is for this reason that, without making it a firm rule, the Commission proposes to authorize Member States to cease (with retroactive effect) to treat as a parent corporation a corporation which would otherwise qualify as such, if that corporation gives up its participation less than two years after having acquired it.

Finally this article gives a definition of a contribution of assets and of a branch of activity.

Article 4

This article contains the fundamental provision for the exemption at the parent corporation level of dividends received from subsidiaries.

This objective has already been realized in part; the present provision will permit this system to be put into general effect at the Community level.

On the other hand, in certain States, the tax exemption only applies to 90% or 95% of the dividends received; the remaining 5% or 10% is considered to represent the expenses of managing the participation, which have already been deducted from the taxable profits of the parent corporation; it is for this reason that this fraction of the dividends is not exempted from tax.

The Commission does not wish to take a side as to the question as to the advisability of taking into account or otherwise such expenses and charges, but it desires that these should not, when they are added back to taxable profits, exceed 5% of the dividends received.

In any event, the proposed exemption ought to apply even in the case of the liquidation of a subsidiary. Indeed experience shows that the taxation, which is generally fairly heavy, of liquidation dividends distributed to a parent corporation, may constitute an obstacle to the liquidation of a subsidiary.

Article 5

Paragraph 1 of this article is intended to exempt from withholding tax the distribution of profits of a subsidiary to its parent corporation when all of the conditions laid down in article 3 are complied with.

It is however necessary to take into account the particular situation existing in Germany. In this country the corporation tax is levied at the rate of 51% on undistributed profits, and at the rate of 15% (effective rate 23.44%) on distributed profits. The exemption from withholding tax at the subsidiary level, which already applies domestically, i.e. in cases where the two corporations concerned are German, is counterbalanced by the imposition, at the parent corporation level, of an adjusting tax (Nachsteuer) of 36%, in cases where the parent corporation does not redistribute the dividends, in order that such dividends suffer tax at the total rate of 51% which applies to undistributed profits.

Since an adjusting tax of this kind does not exist elsewhere, parent corporations of other States having subsidiaries in Germany, would be at an advantage if the dividends received from such subsidiaries were placed in reserve, and German corporations might well be tempted to become subsidiaries of foreign corporations if no corrective were made to the system. Germany has protected itself against this risk by providing in general in such cases, and even in bilateral conventions against double taxation, for a withholding tax of 25%.

Though justified when the dividends received from a subsidiary are not immediately redistributed by the parent, this withholding of 25% is not so justified in the converse case, since in such a case the "Nachsteuer" would not have been imposed if the parent corporation had been German. The imposition of this withholding tax by Germany, as presently occurs in such a case, ought therefore to be abandoned, in order that the German split rate system might once more produce its effect in full. Indeed the achievement of this objective presupposes that a foreign parent corporation should be treated in the same way as a domestic parent corporation.

The second and third paragraphs of this article are intended to solve this problem in such a way that a true tax neutrality may be achieved. It gives to States having a split rate of corporation tax the possibility of imposing a withholding tax where a domestic subsidiary distributes dividends to its foreign parent corporation, it being understood that such withholding tax is refunded where an immediate redistribution of such amounts is

effected by the parent corporation. Moreover, in order to avoid the imposition of withholding tax in cases where this would not be fully justified, the proposed text contains three limitations:

- the withholding tax ought only to be imposed if the rate applicable to distributed profits is at least 10 percentage points below the rate applying in respect of undistributed profits;
- the rate of this withholding tax may not exceed the difference in percentage points between the two rates so applying to profits;
- this rate may not exceed 25%.

Finally it is proposed to authorize corporations to treat profits distributed by them as arising first from dividends received from their subsidiaries, which have suffered such withholding tax.

Article 6

The text of this article is intended to prohibit States from imposing, as is presently done by certain of them, withholding tax on dividends arising from foreign sources and allocated to one of their corporations. Without such a prohibition the proposed exemption from withholding tax at the subsidiary level might well become meaningless. On the other hand, it will be possible for those States to impose a withholding tax when such dividends are redistributed by the parent corporation.

Article 7

This article grants corporations holding participations of at least 50%, the possibility of opting for the system of consolidated profits.

In order to avoid abuses, it is proposed that this system should be compulsory for the entire group of subsidiaries of the same parent corporation within the E.E.C. and that its period of application should be not less than five years. Without these two limitations certain corporations might be tempted to limit the application of such system either to a very short period during which their subsidiaries show a deficit, or only to those of their subsidiaries which are incurring losses.

But it is also proposed that, at the request of the corporation concerned, this system may also apply, during a period of at least five years, to subsidiaries situated outside of the Community. However in this case corporations are given the right to limit the application of this system to subsidiaries in one or more countries. This limitation may seem to be in contradiction with the concern shown to avoid the danger of abuse referred to above. It seems however preferable in such cases to run this risk, which is in any case limited, in order to promote investments by corporations of the Member States outside of the Community and particularly in associated or developing countries.

The working out of all the details of such a system however requires extensive technical examination. It is for this reason that this article provides that the date on which this system will be put into force and the manner in which it should be applied, will be determined at a later date upon the proposal of the Commission. Prior thereto, States which have, like France, introduced such a system into their legal systems may continue to apply it according to the rules laid down in their domestic law.

Article 8

It is proposed that the common system should enter into force not later than January 1, 1971. This somewhat early date was chosen bearing in mind the urgent need to resolve the problem. It nevertheless gives Member States sufficient time in order to make the necessary modifications of their laws and regulations.

PROPOSED DIRECTIVE OF THE COUNCIL

Concerning the common system of taxation applicable in the case of parent corporations and subsidiaries of different Member States

(Submitted by the Commission to the Council)

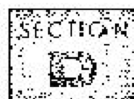
THE COUNCIL OF THE EUROPEAN COMMUNITIES

Having regard to the provisions of the Treaty establishing the European Economic Community, and in particular to Article 100 thereof,

Having regard to the opinion of the Economic and Social Committee,

Having regard to the opinion of the European Parliament,

considering that the regrouping of corporations of different Member States must be made possible in order to create within the Community conditions analogous to those of a domestic market and in order thus to assure the establishment and effective functioning of the Common Market, and that such operations ought not to be hampered by restrictions, drawbacks or distortions arising in particular from the tax provisions of the Member States; that such regrouping does not result in disadvantages insofar as efficient competition and consequently a freedom of activities and of choice remain assured for suppliers, customers and consumers; that this area is governed by the rules concerning competition contained in the Treaties of Rome and Paris; that in this context it is important to introduce with respect to such regrouping of corporations of different Member States, tax rules which are neutral from the point of view of competition, in order to allow enterprises to adapt to the requirements of the Common Market, to increase their productiveness and to improve their competitive strength at the international level;



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considering that such regrouping may be achieved by the acquisition of participations resulting in the formation of groups of parent corporations and subsidiaries;

considering that existing tax provisions which govern the relations between parent corporations and subsidiaries of different Member States, vary appreciably from one State to another, and that this results in serious disadvantages which it is necessary to eliminate by the introduction of a common system in order to avoid such regrouping of corporations being jeopardized;

considering that the common tax system ought, in the first place, to prevent any profits realized by a subsidiary which have already been taxed in its hands, being once more liable to corporation tax in the hands of the parent corporation;

considering that it is furthermore necessary, in order to assure fiscal neutrality, that, except in certain particular cases, the profits which a subsidiary distributes to its parent corporation be exempt from withholding tax;

considering that in particular the system of consolidated profits gives to corporations the possibility of taking into account, for the purposes of computing their taxable profits, any losses suffered by their subsidiaries; that it is therefore necessary to give corporations the possibility of opting for such a system, with respect to all of their subsidiaries situated within the Community;

considering that, in order to promote investments outside of the Community, especially in associated countries and in developing countries, the system of consolidated profits ought also to be available, at the request of the corporations in question, in the case of subsidiaries situated in third countries or in certain of these only;

considering that it is not at present possible to determine the manner in which this system should be applied and the date of its entry into force, and that it is therefore desirable that these matters be finalized at a later date on the basis of proposals made by the Commission,

HAS ADOPTED THE PRESENT DIRECTIVE:

ARTICLE 1

Each Member State shall apply the provisions of the present directive:
- to profits received by parent corporations falling under its domestic law, from subsidiaries falling under the laws of other countries;
- to profits distributed by corporations falling under its domestic law to corporations falling under the laws of the other Member States, of which they are subsidiaries.

ARTICLE 2

The provisions of the present directive concern corporations falling under the laws of Belgium, Germany, France, Italy, Luxembourg and the Netherlands, which are subject to one of the following taxes:
- the Impôt des sociétés in Belgium,
- the Körperschaftsteuer in Germany,
- the Impôt sur les sociétés in France,
- the Imposta sulle società in Italy,
- the Impôt sur le revenu des collectivités in Luxembourg,
- the Vennootschapsbelasting in the Netherlands,

or to any other tax which may be substituted for any one of the above taxes.

ARTICLE 3

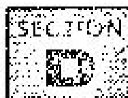
1. For the purposes of the present directive,
   a) at least the following types of corporations are recognized as qualifying as parent corporations:
      - any corporation falling under the domestic law of a Member State, which holds a participation of at least 20% in the capital of a corporation falling under the law of another Member State;
      - any corporation falling under the domestic law of a Member State, which holds a participation in the capital of a subsidiary falling under the law of another Member State, resulting from a contribution of assets irrespective of the amount thereof;
   b) by the term,
      - subsidiary, must be understood a corporation in the capital of which is held a participation referred to in paragraph a);
      - contribution of assets, must be understood the operation by which a corporation contributes, without being dissolved, all of its assets or one or more of its branches of activity, to one or more existing or newly formed corporations in exchange for securities representing a corresponding share in the capital of the corporation or corporations receiving the contribution;
      - branch of activity, must be understood all of the elements invested in a section of a corporation which constitute, from the technical point of view, a separate business, i.e. an entity capable of functioning by its own resources.

2. However each Member State has the right not to apply the provisions of the present directive to corporations falling under its domestic law which do not retain for a period of at least two years a participation qualifying them as parent corporations.

ARTICLE 4

The distributed profits which any parent corporation receives from its subsidiary in its capacity of member of such subsidiary, do not form part of its taxable profits, even if received in connection with the liquidation of such subsidiary.

However each Member State has the right to require a parent corporation falling under its domestic law to



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include in its taxable profits an amount not exceeding 5% of such profits.

ARTICLE 5

1. The profits distributed by a subsidiary to its parent corporation are, at least in those cases where the latter holds a minimum participation of 20% in the capital of the subsidiary or where such participation results from a contribution of assets, exempt from withholding taxes, and in particular:
- from the précompte mobilier in Belgium,
- from the Kapitalertragsteuer in Germany,
- from the retenue à la source in France,
- from the ritenuta alla fonte in Italy,
- from the retenue d'impôt in Luxembourg,
- from the dividendbelasting in the Netherlands.

2. Notwithstanding the provisions of paragraph 1, any Member State in which the rate imposed on distributed profits is lower than that imposed on undistributed profits, may apply a withholding tax on the profits which a subsidiary falling under its domestic law, distributes to its parent corporation insofar as:

a) the rate applicable to the distributed profits is at least 10 percentage points less than that imposed on undistributed profits;

b) the rate of the withholding tax does not exceed the difference in percentage points between the rates applying in respect of distributed and undistributed profits, and does not in any case exceed 25% of the distributed profits.

3. A Member State which has, under the provisions contained in paragraph 2, applied a withholding tax on the profits of a subsidiary, is obliged to make a refund of the tax so withheld to the parent corporation when the latter redistributes such profits in the same financial year.

Such a refund is made in proportion to the profits thus redistributed by the parent corporation which nevertheless has the right to attribute, by priority, to any profits it so redistributes the profits of its subsidiaries, which have suffered such withholding tax.

ARTICLE 6

The Member State of the parent corporation may not impose any withholding tax on the profits which such corporation receives from its subsidiary.

ARTICLE 7

1. Any parent corporation falling under the law of a Member State, which holds a participation of at least 50% in the capital of a corporation falling under the law of another Member State, may opt for the system of consolidated profits for a period of at least five years.

2. As regards the Member State of a parent corporation which opts for the system of consolidated profits referred to in paragraph 1, such system will have the effect;

a) of including in the taxable base for the purposes of the tax imposed on the profits of the parent corporation, in proportion to the capital held by such corporation,
- the profits and losses of all of the corporations falling under the law of the Member States, in the capital of which the parent corporation holds a participation of at least 50%, such balance being computed by reference to the domestic rules of the Member States of the subsidiaries in question;
- at the request of the parent corporation, the profits and losses, computed according to the same rules, of all of the corporations falling under the laws of other States, countries or territories or of certain of these only, in the capital of which the parent corporation holds such a participation;

b) of reducing the amount of the domestic tax falling on the profits of the parent corporation, in order to take into account the fact that the corporations, the profits of which are included in the taxable base, are subject to tax on such profits.

3. The Council shall, by unanimous decision and on the proposal of the Commission, at a later date determine the manner in which the system of consolidated profits shall be applied, as well as the date upon which the Member States will be obliged to introduce this system into their legal systems.

ARTICLE 8

The Member States shall enact the necessary laws, regulations and rules in order to comply with the provisions of the present directive not later than January 1, 1971 and shall immediately thereupon inform the Commission thereof.

ARTICLE 9

As from the date of receiving notice of the present directive, the Member States shall see to it that the Commission is informed, in good time so that it may offer its comments thereon, of any subsequent draft containing the necessary laws, regulations or rules which the Member States envisage adopting with respect to the matters dealt with in the present directive.

ARTICLE 10

The present directive is addressed to the Member States.