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Tesi di dottorato "“Circulation of Taxation Models among Industrialized Countries: Participation Exemption and Interest Deductibility Limitations in Germany, Italy, Austria, Switzerland”"
di ALTMANN MAXIMILIAN HELMUT
discussa presso Università Commerciale Luigi Bocconi-Milano nell'anno 2012
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CHAPTER I. A BRIEF INTRODUCTION TO INTERNATIONAL COMPARATIVE TAXATION: METHODOLOGY OF RESEARCH

There are currently only a few academic studies in the field of International Tax Law treating the concept of International Comparative Taxation from a broad and comprehensive theoretical or practical point of view.

Important scholars deal with problems and aspects of international tax law as a separate supranational system of taxation, while others produce important commentaries and guidelines for the set of domestic international tax rules which apply for international operations.[1] International Comparative Taxation however, being a field of study analysing different international tax models in their domestic use, adopts a completely different approach as it is not problem-orientated and as it makes purely theoretical annotations and has strong international aspects because of its field of study, it mainly observes national tax models due to the fact that it is a field of study which supports policy choices and not practitioners' aspects.

Outstanding pieces of science in this field tend to deal with the concept of International Comparative Taxation by analysing different international tax legislations from an isolated point of view and by using a rather descriptive approach.[2] Other scholars produced important pieces of work by giving first guidelines regarding the theoretical and methodological foundations of this

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[1] GUY GEST AND GILBERT TIXIER, DROIT FISCAL INTERNATIONAL (1990); JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME (2002); OTTO H. JACOBS, INTERNATIONALE UNTERNEHMENSBESTEUERUNG (2002); JACQUES MALHERBE, DROIT FISCAL INTERNATIONAL (1994); HOWARD R. OBERSON AND XAVIER HULL, SWITZERLAND IN INTERNATIONAL TAX LAW, (2002); HARALD SCHAUMBURG, INTERNATIONALES STEUERRECHT (1998); ALBERTO XAVIER, DIREITO TRIBUTARIO INTERNACIONAL DO BRASIL, (2000); CARLO GARBARINO, MANUALE DI TASSAZIONE INTERNAZIONALE (2009); GIUSEPPE CORASANITI, VICTOR UCKMAR , PAOLO DE' CAPITANI DI VIMERCATE, DIRITTO TRIBUTARIO INTERNAZIONALE – MANUALE (2009).

[2] HUGH J. AULT AND BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (2004).

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academic subject.[3] Still there is no broad comparative work which, based on the first available guidelines, selects certain topics in order to analyse them in their application in different countries. Such a work shall have the aim of gaining some useful information also from the point of view of the transposition of the aforementioned theoretical guidelines into the practical tax scene of a selected national tax system.

The aim of this thesis is, as illustrated in the following paragraphs, to give an overview on the theoretical and methodological assumptions developed recently in the field of international comparative taxation, discuss the achievability and utility of the different schemes for legal comparison, select the most probable method to bring good results and, for the core part of the analysis, apply this chosen method for a comparative analysis of certain tax aspects present in selected industrialized countries.

1. A methodology in International Comparative Taxation?

A start for the exact description of the discipline could be to say that it "*involves more than just describing the rules of another legal system*"[4] and that it could be described as a "*separate discipline […], a theoretical framework*".[5] This leads somebody to say that at first glance International Comparative Taxation is a technique and some sort of method of research.[6] It comes to us that there is no common opinion about the circumstance that comparative law can be

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[3] Carlo Garbarino, An Evolutionary Approach to Comparative Taxation: Theory, Methods and Agenda for Research, BOCCONI LEGAL STUDIES RESEARCH PAPER (2007); Carlo Garbarino, Tax Transplants and Circulation of Corporate Tax Models, BOCCONI LEGAL STUDIES RESEARCH (2009); Omri Y. Marian, The Discursive Failure in Comparative Tax Law, 58 AMERICAN JOURNAL OF COMPARATIVE LAW 2 (2010); CARLO GARBARINO AND PAOLO M. PANTEGHINI, CORPORATE TAXATION IN EUROPE: COMPETITIVE PRESSURE AND COOPERATIVE TARGETS in GREG N. GREGORIOU AND COLIN READ C. (EDS.), INTERNATIONAL TAXATION HANDBOOK (2007).

[4] Victor Thuronyi, *What can we learn from Comparative Tax Law*, 103 TAX NOTES 459, 459 (2004).

[5] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation: Methods and Agenda for Research, 57 AMERICAN JOURNAL OF COMPARATIVE LAW 677 (2009).

[6] Omri Y. Marian, *The Discursive Failure in Comparative Tax Law,* 58 AMERICAN JOURNAL OF COMPARATIVE LAW, 2 (2010).

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categorized as an "academic discipline".[7] The discussion is set between those who understand it as methodology of legal research[8] and those that are of the same opinion from a normative point of view but see it more relevant practically,[9] to finally reach those academic circles that consider it as an independent source of knowledge.[10]

2. Methodology in International Comparative Taxation

Among scholars in the field of comparative law there is a long and vigorous discussion about the correct approach to be used for the comparison of different legal systems. Although some scholars criticise the absence of a clear and reciprocal discussion between different tax academics concerning the defence of their, one must admit, very varying approaches to the latter subject, a profound analysis of the works presented until now leads to what could be defined as a set of few possible approaches in International Comparative Taxation.[11] Without being exhaustive at this stage, some assumptions appear almost as given.

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[7] PETER DE CRUZ, COMPARATIVE LAW IN A CHANGING WORLD, (2007).
[8] KONRAD ZWEIGERT AND HEIN KOETZ, AN INTRODUCTION TO COMPARATIVE LAW, (1998); KAMBA, *Comparative Law: A Theoretical Framework*, 23 INT'L COMP. L.Q. 485, 489 (1974); KAHN FREUND, Comparative law as an academic subject, 4 (1965).
[9] JAMES GORDLEY, *Is Comparative Law a Distinct Discipline?* 46 Am. J. Comp. L. 607 (1998).
[10] MATHIAS REIMANN, The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century, 50 A. J. Comp. L. 671, 673-684 (2002).
[11] HUGH J. AULT AND BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS (2004). VICTOR THURONYI, COMPARATIVE TAX LAW, (2003); Henry B. Gardener, *Comparative Taxation* 9 (213) SCIENCE 218; Edward Atkinson, *Comparative Taxation*, 9 (214) SCIENCE 214; Henry B. Gardener, *Comparative Taxation*, 9 (216) SCIENCE 296; John C. Chommie, *Why Neglect Comparative Taxation?* 40 MINN. L. REV. 219 (1956); John C. Chommie, *A Proposed Seminar in Comparative Taxation*, 9 J. LEGAL. EDUC. 502 (1957); VICTOR THURONYI (ED.), TAX LAW DESIGN AND DRAFTING I (1996); VICTOR THURONYI (ED.), TAX LAW DESIGN AND DRAFTING II (1998); Livingston, Law, Culture, and Anthropology, supra note 3, at 124-129; Michael A. Livingston, *From Milan to Mumbai, Changing in Tel-Aviv: Reflections of Progressive Taxation and Progressive Politics in a Globalized but Still Local World*, 54 AM. J. COMP. L. 555 (2006). Michael A. Livingston, *Radical Scholars, Conservative Field: Putting Critical Tax Scholarship in Perspective*, 76 N. C. L. REV. 1791, 1793 (1998); Jorg MANFRED MOSSNER, WHY AND HOW TO COMPARE TAX LAW, in LIBER AMICORUM LUC HINNEKENS (2002). Carlo Garbarino, *Tax Transplants and Circulation of Corporate Tax models* (2009), supra note 3; Anthoni Infanti, *A Tax Crit Identity Crisis? Or Tax Expenditure Analysis,*

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The study of tax systems should be put in place as a whole, even having a given focus on certain corporate tax models because "comparative tax studies should not be limited to artificially isolated topics but should include tax systems considered as complex evolutionary structures".[12]

Furthermore, the objective must be to describe distinct corporate tax models, as it comes clear that comparative analysis in taxation shall be carried forward by looking at "the competition of specific tax structures and not of tax systems as a whole."[13] What sounds like a contradiction to the above will be explained in the following paragraphs. Tax systems as a whole however, should be presented as legal containers which include specific tax rules.

A insightful analysis in comparative taxation must be based on the use of the functional approach. Although functionalism for the purposes of comparative studies is subject to a long-lasting critique, it seems that no other valuable alternative comparative method can be adopted in this field of research. What is more, a modified version of legal functionalism will be proposed in order to bridge the counterarguments in place.

When putting his functional orientation in practical terms one should, as will be explained, adopt Sacco's legal formants approach in order to study the circulation of tax transplants. In fact, comparative tax scholars should adopt a common core approach, if they are interested in revealing deep structures of convergence.[14]

Deconstruction, and the Rethinking of a Collective Identity, 25 WHITTIER L. REV. 707, 796 (2005).

[12] Carlo Garbarino, supra note 5 at 2.

[13] Carlo Garbarino, supra note 5 at 2.

[14] PIERRE LEGRAND AND RODERICK MUNDY (EDS.), COMPARATIVE LEGAL STUDIES: TRADITIONS AND TRANSITIONS (2003); RUDOLF B. SCHLESINGER, FORMATIONS OF CONTRACTS: A STUDY OF THE COMMON CORE OF LEGAL SYSTEM (1968).

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a. Legal systems as evolutionary networks

This analysis has its focus on a micro level with respect to the potentially available way of analysing legal systems. There have been various interesting attempts to have a broad consideration of the evolution of legal systems,[15] where reference is made to the observation of the itineraries of abstract legal rules. This work, on the other hand, focuses on the concrete application of certain, pre-determined legal rules or models which, once again, is done by concrete comparison between different legal systems. This work is therefore the micro part of broader analysis as mentioned before.[16]

<u>Methods in International Comparative Taxation</u>

As we stated before, International Comparative Taxation is considered by some scholars a source of knowledge. This comparative analysis shall have the purpose of strengthening that opinion and be so precise in its single steps that this becomes explicable.

The method applied here should be the Functional evolutionary approach as it is the only one able to overcome the three typical peculiarities of Tax Law being: Rapid legal change caused by the necessity of the administration to counteract tax base erosion; the complexity of tax systems which results from the many different individual and collective behaviours influencing the matter.[17]

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[15] Carlo Garbarino, A Model of Legal Systems as Evolutionary Networks: Normative Complexity and Self-Organization of Clusters of Rules, BOCCONI LEGAL STUDIES RESEARCH PAPER.
[16] J. B. RUHL, The Fitness of Law: Using Complexity Theory to Describe the Evolution of Law and Society and Its Practical Meaning for Democracy, 49 VAND. L. REV., 1407–90 (1996);
Robert Axelrod, *An Evolutionary Approach to Norms*, 80 AM. POL. SCI. REV., 1095–1111 (1986). ROBERT C. CLARK, The Interdisciplinary Study of Legal Evolution, 90 YALE L. J., 1238 (1981); Donald Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 COLUM. L. REV. 38–94 (1985).
[17] Stanley Warskett, George Winer and Walter Hettich, *The Complexity of Tax Structure in Competitive Political Systems*, 5 International Tax and Public Finance, 127 (1998).

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These are: the opportunistic behaviour of the taxpayers, always trying to minimize the tax burden (self-selecting behaviour),[18] administration costs of the government, deriving from the fact that the tax system has to give a detailed solution for virtually unlimited different cases of situations from real life; the sorting equilibrium, the administration will tend to gather potentially different situations in clusters to minimize administration costs. Additionally, there is heterogeneity of tax concepts: it is a fact that there are certain legal terms in taxation which are difficult to translate accurately.

It appears that the only method useful to overcome those aforementioned peculiarities is the functional method. It concentrates on the function of a specific tax provision and therefore gives the possibility to group countries with provisions having similar functions in clusters giving the chance to analyse them comparatively.

Among one cluster, there are cases where one can find out that diverging rules within the cluster derive from one centre of origin. This grants the possibility to observe the evolution of certain rules and makes the functional analysis evolutionary.[19]

Moreover, Functionalism is a substantial not formal method of analysis: it goes beyond formal legal rules and looks at solutions adopted in different countries;

Through these qualities of Functionalism, International Comparative Taxation is able to address tax models in whatever form they operate (as a set of statutory rules, as judicial doctrine, as administrative guideline, as established patterns of behaviour or as a combination of the above). The important common element must be that similar functions are served through the model.

The benchmark is, so to speak, the function of tax rules within tax systems.[20]

Within the functional method, there are two possible schemes for comparative tax analysis which are the legal formants approach and the common core approach.

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[18] Garbarino, supra note 5 at 3.

[19] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation: Methods and Agenda for Research, supra note 5 at 5; Rodolfo Sacco, Diversity and Uniformity in the Law, 49 Am. J. Comp. L. 171 (2001).

[20] Carlo Garbarino, An Evolutionary and Structural Approach, supra note 5.

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The legal formants approach shows how the basic elements of tax law ("formants") circulate among different countries through legal transplants, and whether and to what extent these mechanisms derive from common tax models. Differently, the common core approach shows which is the common underlying structure of tax mechanisms adopted by different countries, where the legal formants approach and the factual approach in their combination show how tax systems diverge/converge in an evolutionary way.

In conclusion, the adoption of a functional evolutionary approach makes it possible to determine where domestic tax mechanisms come from transplants and circulation of models and why and how they evolve (tax divergence and convergence).

A "tax formant" is any kind of legal proposition that affects the solution of a tax problem.[21] There is an interdepending relationship between single legal formants, which can be summarized as[22] the creation of legal provisions by all possible formants, namely: administrative guidelines, case law, the academic field with the contemporary effect that administrative guidelines usually resist versus the interpretation and judgments given by the academic world. It is clear that case law is influenced strongly by academic findings and vice versa and that case law is often the basis for new principles influencing the academic field via interpretation.
Furthermore, judicial principles stated by case law are often in conflict with administrative guidelines, but in specific cases influence administrative guidelines. An example could be an administrative principle which is repeatedly broken down by courts and consequently not reiterated by the government.

Within a single country there is often *competition among tax formants.*[23] The analysis of formants on a multi-country level has to be considered a

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[21] Rodolfo Sacco, *Legal Formants, a Dynamic Approach to Comparative Law*, 39 Am. J. Comp. L. 1 and 343 (1991).
[22] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation, supra note 5.
[23] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation, supra note 5.

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comparative method. Analogies of operative rules are resulting in tax convergence, while when there are differences of operative rules there is tax divergence. The comparative analysis through the observation of formants can be put in place in a given moment in time (synchronic plane), or over time (diachronic plane).

This again could put the focus on the changes present in the scientific field, coming to a characteristic of evolutionary description of the processes that have led to a given situation. The evolutionary quality of legal formants in this respect has its vehicle in the circulation of tax models: the outcome is four-fold: 1) analogies of operative rules in the synchronic plane as result of tax transplants or the endogenous development of similar tax rules by two tax systems, not influencing each other; 2) differences of operative rules in the synchronic plane: two or more countries in many cases achieve a different result by using different tax formants; 3) analogies of operative rules in the diachronic plane: tax continuity and tax convergence among different national solutions to tax problems; 4) differences of operative rules in the diachronic plane: tax innovation.

In this respect, the term Tax transplant in the strict sense means a transfer of tax mechanisms between different countries which is imported from country C (exporting country) for example into country A and country B (importing country). What is more, Hybrid tax transplants are a special type of Tax Transplants as they define transplants' substantially modified operative rules in the process of being transplanted.

It is very often the case that new tax mechanisms have a closer relationship with international tax models than the domestic tax system itself. Therefore, the study of them shows new boundaries of comparative taxation.[24]

As state above, the second element of the functional method as used for the purpose of this analysis, should be the so called Common Core Approach. The methodological basis is more than consolidated, it is one of the methods most

[24] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation, supra note 5.

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discussed by all comparatists:[25] it consists in the direct confrontation of answers given by local jurists to a set of common questions based on common problems.[26] Tax complexity as explained afore makes it hard to find a unitary set of questions to be answered by tax experts in the process of a common core analysis.

Through Comparative institutional analysis one comes to the important aspect of tax design which deals mainly with the institutional efficiency of a tax mechanism, not strictly its economic impact.

The analysis of a single formant for solving a tax problem is put in place through the observation of a continuum which goes from a "top-down pattern" to a "bottom-up pattern": the first is done by tax statutes, the latter is solved by operation of administrative guidelines in conjunction with case law and/or opinions of the scholars without the use of legislation.

This leads us to an important annotation: the institutional approach to tax design has a comparative dimension because an institutional decision (the selection of a given tax mechanism to address a tax problem) implies the analysis of alternative tax models in other countries.[27]

Putting the focus on the time sphere in which a dynamic comparative analysis is done, it is certainly the case that a useful time scale in this academic field should have a length of 5 to 10 years. This is the period of time in which those models particularly relevant for corporate taxation are evolving. Other formants of tax systems are more suitable for a static comparative analysis. This concerns at least the principles of general tax law.

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[25] KONRAD ZWEIGERT AND HEIN KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW, (1998); LEONTIN-JEAN COSTANTINESCO, TRAITÈ DE DROIT COMPARE, (1972); RUDOLF SCHLESINGER, HANS BAADE, MIRJAM DAMASKA AND PETER HERZOG, COMPARATIVE LAW: CASES, TEXT AND MATERIALS, (1988).
[26] RUDOLF SCHLESINGER, COMPARATIVE LAW, supra note 14; RUDOLF SCHLESINGER, FORMATION OF CONTRACT supra; RUDOLF SCHLESINGER, THE COMMON CORE OF LEGAL SYSTEM, supra; RUDOLF SCHLESINGER, THE PAST AND THE FUTURE OF COMPARATIVE LAW.
[27] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation, supra note 5.

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Further methodological developments

This chapter examines some additional remarks on the methodological framework of International Comparative Taxation. As we stated above, the best method to be applied in this respect is Comparative Evolutionary Analysis which could be enriched by concepts of tax competition to explain the actual selection of one determined tax model and not the other.[28] This has an effect in answering the question about reasons and characteristics of corporate tax transplants. One first explanation for tax policy transfer is that countries in their limited knowledge use a sort of benchmarking process concerning solutions adopted by other legislations. The process itself is complicated and already explained and analysed by distinct scholars.[29] What is important at this stage is that the result of the process is the obligation to observe the process in an evolutionary setting. The next fact is that there is an entire publication on the exact description of the concept "tax transplant" itself. It is definitely compound and dense as it involves certainly more than just a mere transposition of external rules.

Concerning tax models and tax solutions, one could say that being the actual implementation of certain formants at the local level, the first represents the translation of the latter in a scheme which can travel internationally. A tax model can therefore be defined as certain policy paradigm which *serves a functional role in dealing with a policy issue.*[30]

The relationship between the two elements is not unidirectional as certain tax solutions are implemented with the help of international tax models but, again, certain tax solutions adopted on the local level are, again, translated into tax models to give them the ability to circulate internationally. This correlation can be called "glocalisation."[31]

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[28] Carlo Garbarino, C., Tax Transplants and the Circulation of Corporate Tax Models, BRITISH TAX REVIEW, 159 (2011).
[29] Carlo Garbarino, Tax Transplants and the Circulation, supra note 28.
[30] Carlo Garbarino, Tax Transplants and the Circulation, supra note 28.
[31] Carlo Garbarino, Tax Transplants and the Circulation, supra note 28.

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Coming back to the concept of competition the aforesaid leads to the opinion that on the international scene there is a process of competition between tax models eventually selected by different tax systems. The success of those models can be weighed according to the number of countries adopting a certain model.

At the beginning of this thesis we explained the important concepts of tax transplants and hybrid tax transplant. A third case of corporate tax transplant in this respect is represented by combined tax transplants, which have the meaning of transplants with a shift from one originary legal formant to another, for example a statutory thin capitalization provision of country A is introduced in country B but through administrative guideline.
Conceptually thinking, the concept of circulating international tax models can also be described as the combination of two different scientific phenomena: policy transfer and diffusion of innovation.[32] Policy transfer is defined as *adaptation in which the deliberate choice of the policymaker assumes a central role*.[33] That process is put in place through the concepts of copying, emulation, hybridization, synthesis and inspiration.[34]
The studies of diffusion[35] typically concentrate on the abstract spread of certain policy models and use modeling mainly from mathematics and other scientific fields.

According to what was mentioned above this thesis studies certain tax models, analysing them in the context of bigger tax systems considered as complex evolutionary structures."[36] Nonetheless, we will observe certain tax structures from a closer point of view, concentrating our analysis on the treatment of profit distributions and inter-company loans. We use the functional approach: although functionalism for the purposes of comparative studies is subject to a

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[32] Carlo Garbarino, Tax Transplants and the Circulation, supra note 28.
[33] EVANS, Policy transfer in global perspective, Ashgate, 2004.
[34] OLIVER JAMES AND MARTIN LODGE, *The Limitations of 'Policy Transfer' and 'Lesson Drawing' for Public Policy Research,* 1 UNIVERSITY OF EXETER POLITICAL STUDIES REVIEW: 179–193 (2003).
[35] EVERETT ROGERS, 2003: THE DIFFUSION OF INNOVATIONS. FIFTH EDITION. THE FREE PRESS, NEW YORK.
[36] Carlo Garbarino, cited work, supra at 2.

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long-lasting critique, it seems that no other valuable alternative comparative method can be adopted in this field of research. Moreover, a modified version of legal functionalism will be proposed in order to bridge the counterarguments in place. This, in practical terms, means also that Sacco's legal formants approach will be adopted in order to study the circulation of tax transplants. In fact, comparative tax scholars should adopt a common core approach if interested in revealing deep structures of convergence.[37]

b. Selection of countries and models analysed in this work

The discussion about the right countries to be selected for comparative purposes is vivid but equivocal. It is true that Thuronyi elaborated concepts for the classification of tax systems[38] but his classification "largely tracks the classification of legal families by comparative law scholars".[39]
Critics affirm that the determination of legal families finds its basis in comparative private law. This is true, but Thuronyi's effort deals with the conversion of the legal family notion from private to tax law.
Barker,[40] on the contrary, adopts a different approach: asserting that the notion of legal families is a proper starting point for comparative research, he uses a normative approach and describes comparable tax systems as legislations characterized by similar basic structures.
Livingston[41] goes further and shows a mixed approach: starting with the notion of legal families, he reaches the opinion that the selection of comparable tax systems shall be pursued splitting the functional approach in its two basic

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[37] PIERRE LEGRAND AND RODERICK MUNDY (EDS.), COMPARATIVE LEGAL STUDIES: TRADITIONS AND TRANSITIONS, 345 (2003); RUDOLF B. SCHLESINGER, FORMATIONS OF CONTRACTS: A STUDY OF THE COMMON CORE OF LEGAL SYSTEM (1968).
[38] VICTOR THURONYI (ED.), TAX LAW DESIGN AND DRAFTING I (1996); VICTOR THURONYI (ED.), TAX LAW DESIGN AND DRAFTING II (1998).
[39] VICTOR THURONYI , supra note 25.
[40] William Barker, Expanding the Study of Comparative Tax Law to Promote Democratic Policy: The Example of the Move to Capital Gains Taxation in Post-Apartheid South Africa, 109 PENN. ST. L. REV. 703, 703-716 (2005).
[41] MICHAEL A. LIVINGSTON, LAW, CULTURE, AND ANTHROPOLOGY, supra note 3, at 124-129; Michael A. Livingston, From Milan to Mumbai, Changing in Tel-Aviv: Reflections of Progressive Taxation and Progressive Politics in a Globalized but Still Local World, supra at 11.

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elements: the level of development of the tax system and the functional equivalence of tax rules.
Chommie[42] suggests a comparison between countries which have a comparable economic, political and linguistical background.

As will be explained in this thesis, all approaches present problems difficult to surmount: each theory is somehow biased and not suitable for an objective research, all together are brilliant and relevant discussions are born. The most progressive approach at this stage seems to be the one that considers comparisons suitable in cases of comparables which adopt *tolerably fit corporate tax solutions,*[43] as a comparison on this basis goes beyond the discussion of legal families for tax purposes and preconceptions given by the search of comparables with similar social, legal, political and economic basis. The key for such an approach could be to compare tax systems which present an akin level of *fitness,* which means that they present tax mechanisms with the same aim at a similar level of evolution. This is exactly the case of the countries analysed in this thesis. Last but not least, it seems interesting to analyse countries which have dealt with the same tax problems from a global perspective and did this by introducing different tax rules.

What comes next is a discussion about the actual object of comparison; the decision whether to compare micro elements of a tax system or the tax system as a whole. It should be mentioned at this stage that one of the most interesting aspects in the field of corporate taxation is the tax treatment of operations between the corporation itself and its shareholders, whether natural persons or legal entities. These operations can result even more complex in cases of cross-border operations. The typical operations arising are distributions of profit, transfer pricing and payments of interest for intercompany loans. We speak of complexity as result of probability of tax assessments, tax trials, possibility of tax saving policies and valuation problems, facts that come together and are confirmed by a vivid activity of any legislator in this field. This leads to the conclusion that the aforementioned field of taxation is somehow

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[42] John C. Chommie, *Why Neglect Comparative Taxation?*, 40 MINN. L. REV. 219 (1956); John C. Chommie, *A Proposed Seminar in Comparative Taxation*, 9 J. LEGAL. EDUC. 502 (1957).
[43] Carlo Garbarino, supra note 5 at 2.

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critical to the tax system as a whole, which is an affirmation that makes a synthesis of the aspects proposed in the discussion.[44] Nonetheless, one must explain why a specific area of tax is a better candidate for comparison than others. Barker suggests studying the defining elements of a tax system,[45] but explains his opinion only on an ideological basis; other comparatists have a more practical approach.[46]
At present there is no clear mainstream for the decision whether to compare two or more tax systems, the selection of the tax systems themselves and the comparison of tax systems as a whole or only certain tax mechanisms. The discussion includes a range from all-inclusive academics with a worldwide perspective in their studies to academics adopting a bilateral approach, finding it sufficient to compare only two jurisdictions.

Speaking about the actual object of comparison, some perceive tax comparison as a wide matter which demands a universal examination of tax systems as "wholes," whilst others look at constricted issues expressly to steer clear of this generalization. It should be remembered that in the analysis of corporate tax transplants we shall distinguish two different levels: global and local. At the global level, there is circulation of "tax models" among different countries. At the local (national) level there is regulatory articulation of domestic "tax mechanisms" as responses to tax policy issues.[47]

This work follows a global approach, as it has the clear aim to follow corporate tax models and their circulation. Nonetheless it will occur that various aspects of the local level will be highlighted to comprehensively understand the nature

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[44] Carlo Garbarino, An Evolutionary and Structural Approach to Comparative Taxation, supra note 5; William B. Barker, A Comparative Approach to Income Tax Law, supra; William B. Barker, Expanding the Study of Comparative Tax, supra note 11; VICTOR THURNOYI, COMPARATIVE TAX LAW, supra; Antony C. Infanti, Spontaneous Tax Coordination, supra; Michael Livingston, Law, Culture, and Anthropology, supra note 3.
[45] Exemptions and tax preferences are the defining elements of a tax system and are critical to the comparative study of tax law. Exemptions and preferences strongly indicate whether the ideals of equity and distribution are being achieved by a particular system because they are the sources of the vast majority of direct tax transfers in William B. Barker, *Expanding the Study of Comparative Tax Law* supra note11.
[46] Carlo Garbarino, Victor Thuronyi, supra note 1.
[47] Carlo Garbarino, *An Evolutionary Approach*, supra note 28.

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of the discussed corporate tax models. This approach comes close to what has been defined as "glocalization,"[48] which combines the word globalization with localization. The term has emerged in economic, sociological, and cultural studies to identify the relationship between global and local processes, which are increasingly viewed as being two sides of the same coin rather than direct opposites.

This thesis concentrates on corporate taxation as a macro-category of a tax system and specifically on the tax treatment of profit distributions and debt financing, which appear to be the two most relevant categories of corporate taxation. Significant reforms have occurred in these two areas and it seems that those reforms could have had a sort of reciprocal relationship. A consequence of such an approach is the obligation to bear in mind that not only is there tax competition among countries, but also tax competition among domestic mechanisms, which makes it relevant to compare specific mechanisms from a local or domestic point of view if they deal with similar or comparable tax problems. This said, one could come to the conclusion that those aforementioned tax reforms were somehow influenced by what are commonly called international tax models which, again, could be proven to circulate among advanced tax systems, having the ultimate effect of making domestic tax systems converge into a macro category with similar tax rules. This thesis intends to analyse the outcomes of corporate tax evolution, which could result in the establishment of different clusters of countries by scrutiny of different tax mechanisms and the competition of specific tax structures (not of tax systems as a whole). The result of partial tax convergence is that corporate tax mechanisms tend to become more efficient by articulating specific features in the process of current tax policy and reform.
The aforementioned means the classification of such countries in two groups: (i) fully converging and diverging systems or (ii) partially converging (or partially diverging) systems.[49]

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[48] Carlo Garbarino, *An Evolutionary Approach*, supra note 28.
[49] CARLO GARBARINO, TAX TRANSPLANTS AND CIRCULATION OF CORPORATE TAX MODELS, BOCCONI LEGAL STUDIES RESEARCH.

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The term tax convergence/divergence refers to the characteristics of the tax system and specific tax models present in the tax system itself. One should consider that the corporate tax policy of an individual country (i.e. the selection of a certain tax mechanism) often depends on how many other individual countries adopt the same.[50] This make an analysis such as the one carried forward in this thesis necessary to collect examples for the adoption of similar tax models, the fact that they are converging or not, in order to have the possibility to assess if a certain tax mechanism, present in different legal system, can ultimately be defined a tax model from an international perspective.

Coming to the next aspect, one should consider that the study of tax transplants and the circulation of tax models, and that comparative analysis is only significant under the condition of being "evolutionary", which means that the analysis of different tax models should answer the question which elements of a given domestic corporate tax mechanism have developed domestically and which have developed through adaption of international models.
One should therefore study a domestic corporate tax mechanism from an historic point of view, which means that one should link it to tax mechanisms previously developed in other countries and, more generally, to a tax model which is present in a series of countries.
If tax transplants were a relevant way for the circulation of corporate tax models important features of current tax policy would arise. First, transplants can create convergence among different corporate tax systems. Second, transplants may contribute to the explanation of the common core of corporate tax systems (different transplants of the same model tend to show similar features). Third, transplants offer a strong challenge to the idea that tax law is exclusively a local response to social demands felt by a specific national community.[51]

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[50] Stanley J. Liebowitz and Steven E. Margolis, *Market Processes and the Selection of Standards*, 9 HARV. J. L. & TECH., 283–318 (1996); Francesco Parisi, *The Cost of the Game: A Topology of Social Interactions*, 9 EUR. J. LAW & ECON., 99–114 (1997); Richard M. Buxbaum, *Is Network a Legal Concept?*, 149 J. INST'L. & THEORET. ECON., 698–705 (1993).
[51] Rodolfo Sacco, supra note 2.

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3. Brief overview of the research

This research focuses on three basic corporate income tax models: the limitation of interest deduction, the exemption of intercompany dividend, the exclusion of intercompany capital gains. These three models have a special position concerning the relationship between shareholders and the relevant company. Modern times accelerated the circulation of certain capital. The fast movement of means of capital is to be seen as one of the fundamental qualities of globalization or as one of the conditions of it. As a matter of fact, every developed country plays on the market of capital attraction with the consequent attempt to design its tax system in accordance with modern and efficient conditions, making it interesting for international investors.

The other side of the coin is the fundamental necessity to stabilize the tax base of industrialized nations: the fast development of the economy and the easy possibility to localize production factors and herein principally capital in any desired country makes it a hard run to save the domestic tax base.

In that run, distributions of dividends and payments of intercompany interest are the principal flow of capital remuneration. Modern tax system understood that it is useless to concentrate on the taxation of capital as it is not easy to be analysed and consequently taxed. The clear concentration of the resident entity´s profits and the atypical outflows before the determination of the taxable profit, namely interest payments by deduction and after the determination of the taxable profit, namely payments of dividends, are the framework of modern corporate tax law.

It is a matter of fact that, concerning the tax treatment of those afore mentioned circumstances, dividend distribution with eventual disposal of shares and payment of intercompany interest, there is an international convergence around a limited set of taxation models. As an attempt to develop a common scheme for International Comparative Taxation, a starting point based on a closer analysis of these three situations looks very promising as it seems that the different ways of tax treatment are aimed at solving common tax problems, namely control and taxation of international flows of capital, and as the possible tax mechanism and connected models of taxation are special rules, distinguished from the ordinary set of rules for income determination.

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The tax problem of thin capitalization and international efficiency of dividend and capital gain taxation are not easily answerable by ordinary rules of income determination as the first of the two problems is highly linked to the tax system as a whole and spreads its effects only in a moment subsequent to the one of income calculation and the second, being positioned in the field of avoidance, concerns a situation which could be dealt with through general anti-avoidance rules which, concerning such a category of cost as financing expenses, leads to extremely high administration costs.

The two tax problems are, so to speak, answerable by a limited series of ways which makes the number of possible models more limited and the analysis more feasible.

This thesis deals with a set of countries connected in many ways such as common legal tradition, language, membership in supranational organizations and economic development. It seems that, keeping in mind the aforesaid, the analysis of the taxation models of thin capitalization rules and participation exemption regimes in exactly these countries allows an analysis which has the effective possibility to concentrate on the theoretical framework of International Comparative Taxation as the selection of these specific countries is the reduction to a minimum of all possible problems arising in comparative tax law.

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CHAPTER II. EROSION OF THE NATIONAL CORPORATE TAX BASIS THROUGH THE DEDUCTION OF INTEREST

1. The Adoption in Germany of the so-called "EBITDA rule"

As seen initially and proposed by the academic world, the German legislator adopts a classical interest deductibility barrier.[52] The main reason for the introduction of such a rule consists in finding necessary funds to finance a substantial reduction of the corporate tax rate.[53] Moreover, there are systematic reasons such as the fact that the legislator considers that the deduction of interest has been tied to earnings so that groups will tend to transfer their income to Germany,[54] although this justification for the introduction of the rule is criticised by part of the academic world.[55] Also the compatibility with European law is criticised by many scholars.[56]

a. A brief description of the model

Debt from a tax perspective

The first subsection of Section 4h deutsches Einkommenssteuergesetzbuch[57] contains the basis of the EBITDA rule. In particular, the interest expenses of a company can be deducted only up to 30% of fiscal EBITDA. According to Section 4h, I, 2 dEStG, non-deductible interest expenses can be carried forward to the following years.

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[52] Dorotee Hallerbach, *Einführung einer Zinsschranke im. Entwurf eines Unternehmensteuerreformgesetzes 2008*, STEUERN UND BILANZEN 293 (2007); Stefan Köhler, *Erste Gedanken zur Zinsschranke nach der Unternehmensteuerreform,* DEUTSCHES STEUERRECHT 597 (2008); Thomas Rödder and Ingo Stangl, *Zur geplanten Zinsschranke,* DER BETRIEB 479 (2007); WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011).
[53] Wolfgang Kessler and Rolf Ecke, *New German Thin Cap Rules – Too Thin the Cap*, 47 TAX NOTES INTERNATIONAL 263 (2007).
[54] BT-Drucks 16/4841.
[55] *Stefan Köhler*, supra note 52, at 604.
[56] *Thomas Rödder and Ingo Stangl*, supra note 52, at 479.
[57] deutsches Einkommenssteuergesetz German Income Tax Act, officially cited as "Einkommensteuergesetz in der Fassung der Bekanntmachung vom 8. Oktober 2009 (BGBl. I S. 3366, 3862), das zuletzt durch Artikel 20 des Gesetzes vom 20. Dezember 2011 (BGBl. I S. 2854) geändert worden ist", from now on dEStG.

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The second subsection of Section 4h dEStG provides for three escape clauses, thanks to which, when the provided conditions are met, the EBITDA rule does not apply and interest expenses are fully deductible. Such escape clauses are a free limit of 1 Million €; the so called "Stand-Alone Clause"; the so-called "Escape Clause".

Section 4h dEStG is based on the determination of profit. Therefore this concerns all companies and only those that earn a profit: consequently Section 4h dEStG regards sole traders, partnerships and joint-stock companies, as well as public and non-profit trading companies.
With regard to corporations, Section 8a, subsection 1, deutsches Körperschaftssteuergesetz[58] actually specifies that, when applying Section 4h, I, 1 dEStG, which states the basic rule, the income must be used instead of the profit. In this way, hidden distribution of dividends will also be taken into account. Nevertheless, the presence of taxable income constitutes a prerequisite. According to Section 15, I, 3 dKStG, the whole group is treated as if it were a company.

European law issues

The legal doctrine has strong concerns about the compatibility of the German Interest barrier rule with constitutional, international and European sets of rules.[59] Concerning the set of rules given by communitarian law, it has to be

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[58] Deutsches Körperschaftssteuergesetz, German Corporate Tax Act, officially cited as "Körperschaftsteuergesetz in der Fassung der Bekanntmachung vom 15. Oktober 2002 (BGBl. I S. 4144), das zuletzt durch Artikel 4 des Gesetzes vom 7. Dezember 2011 (BGBl. I S. 2592) geändert worden ist," from now on dKStG.

[59] Lorenz Bernhard and Dieter Endres and Sabine Gregier and Markus Hüllmann and Manfred Karges and Martin Liebernickel and Christine Marx and Lukasz Mehl and Andrew Miles and Achim Obermann and Guido Schäferand Margot Voß-Gießwein and Annekatren Werthmann-Feldhues and Sönke Wulf, Steueränderungen 2010, Haufe Lexware 98 (2010); Adalbert Rödding, *Änderungen der Zinsschranke durch das Wachstumsbeschleunigungsgesetz* Deutsches Steuerrecht 2649 (2009); Stephan Eilers and Franziska Bühring, Deutsches Steuerrecht 137 (2009); Stephan Viskorf: *Bericht zum 1. Münchner Unternehmenssteuerforum: Sofortprogramm krisenentschärfende Maßnahmen – Die Entschärfung der Verlust- und Zinsabzugsbeschränkungen durch das Wachstumsbeschleunigungsgesetz*, Exhibit to 7 Deutsches Steuerrecht 1 (2010).

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mentioned that the point considered most critical is the freedom of establishment as the rule concerns international group of enterprises.

The freedom of establishment rule mainly protects direct investments in communitarian countries, whether done by subsidiaries (Section 43 and 48 ECT) or by means of other form. Secondly, concerning the jurisprudence of the ECJ, there has to be the same treatment for similar conditions. Discrimination is not permitted, no matter if put in place openly or surreptitiously. It does not seem that the first conditions of the German interest barrier rule could be seen as discriminatory towards foreign investors. What becomes quite clear coming to the end of the written rule, is that the conditions of non-applicability for fiscal groups is indirectly discriminating for foreign investors as the German rule on fiscal units is not applicable to non-resident companies in any way. German rules on fiscal units do not accept international fiscal groups, Section 14, subsection 1 dKSTG. Reasons of coherence could not be used to allow the discrimination: it is clear that we are dealing with at least two different companies while the argument of coherence can be used only if the same tax and the same company is concerned. As stated above, there could not be any use of the criterion of territoriality as we speak of deductibility with reference to the German company.[60]
This leads to the argument of limitation of tax abuse which again must be respecting the rule of proportionality. It is quite evident that the German rule is useful in reducing tax abuse with respect to the thin capitalization of group companies in high tax countries. What is not clear is whether there were no softer ways of implementing that objective. This would mean that the German rule is stricter than necessary and therefore not proportional.

Operative structure of Section 8a TUIR

The central rule concerning the recently introduced interest barrier rule is contained in Section 4h, subsection 1, sentence 1 dEStG. This statutory rule provides that every interest expense of a business is deductible only up to an amount equal to 30 % oft he fiscal EBITDA concerning the same fiscal year.

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[60] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); AXEL CORDEWENER, EUROPÄISCHE GRUNDFREIHEITEN UND NATIONALES STEUERRECHT (2002).

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This rule is seemingly applicable to every kind of lender and to any kind of finance business, whether provided with legal personality or not, with special rules for legal entities as provided for by Section 8a dKSTG.[61] The consequence of such a legal structure is the non-deductibility at the level of the financed entity (with the legal treatment of exceeding interest expenses of Section 4h subsection 1, sentences 2 and 3 dEStG explained afore and the taxation different from the former regulation, as there is no more re-qualification of non-deductible interest in hidden profit distributions and consequent treatment as dividends of the exceeding interest at the lender´s level. Moreover, there is no more applicability of the flat tax of 25% for interest perceived by shareholders from intercompany loans but the regular applicability of the ordinary tax rate. Sec 32d, subsection 2, Nr. 1 lit. a, EStG.

Operative definitions stated for the basic rule

One of the most important definitions to be given for reasons of comprehension of the basic rule is that of the objective scope of application which the German legislator links to the term "*Betrieb*" in Section 4h, subsection 1, meaning business.
Neither in Section 4h dEStG nor in the guidance by the Ministry of Finance of July 4th 2008 is there a comprehensive explanation of the meaning of the term "business" for the purposes needed here. No general definition of the term "business" is given elsewhere. Reference is made through the connection to Section 2, II, No. 1 dEStG and the relevant declaration of the government, BT-Drucksache 16/4835, 1: the term has to be defined with help of Section 15, subsection 2, EStG which states that a (commercial) business is every business that is based on independent and durable action with profit intention.[62]

The guidance by the Ministry of Finance of July 4th 2008 explains that there is a *Betrieb* every time a business income, other kinds of profits provided by Section

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[61] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); Felix Reiche, Robert Kroschewski, Akquisitionsfinanzierungen nach Einführung der Zinsschranke - erste Empfehlungen für die Praxis, 1330 Deutsches Steuerrecht (2007).
[62] BERND ERLE AND THOMAS SAUTER (eds.), HEIDELBERGER KOMMENTAR ZUM KÖRPERSCHAFTSTEUERGESETZ (2010).

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2, II, No. 1 dEStG as well as income deriving from self-employment are earned and that the method used to determine the profit does not have any relevance.

According to the relevant instructions given by the Ministry of Finance,[63] non-resident companies that have a permanent establishment in Germany are within the scope of application of EBITDA rule. Additionally, in accordance with the mentioned guidance, the EBITDA rule is applicable also for cases of simplified profit determination according to Section 4, subsection 3 dEStG, which is valid for those corporations that are only partially subject to taxation, e.g. real estate companies.

Corporations and partnerships are deemed to run only one business for the purposes of the EBITDA rule. Special business assets of the partners of a partnership, not connected with the main object of business are part of the partnership business.

Partnerships with different categories of partners, such as limited partnerships with share capital (*KGaA*) bear only one unitary profit determination for the purposes of the EBITDA rule. According to the definition of commercial activity provided by Section 15, subsection 3, number 2, dEStG, asset management partnerships do not represent a business for the purposes of the EBITDA rule, as their profit is not defined as business income.

Also German branches of non-resident companies do not constitute independent businesses. With reference to group tax consolidation it has to be stated that all businesses run in the fiscal unit are considered are considered as a sole business to the EBITDA rule purposes.

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[63] BMF-Schreiben 4. Juli 2008, Zinsschranke (§ 4h EStG; § 8a KStG).

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b. The Ebitda rule in detail

The scope of the limitations

The German EBITDA rule is applicable to individual personal businesses, partnerships, corporations through the linked system of the basic rule provided by means of the Personal Income Tax Act and the Corporate Income Tax Act.[64]

Permanent establishments in Germany of non-resident companies, being subjected to German corporate taxation, are also included within the scope of application of the EBITDA rule.[65]

We have seen before that, unlike for the case of corporations, which by definition provided by the Ministry of Finance[66] are deemed to run only one business, a sole trader can run many businesses.

The relevance of partnerships in the German economy has lead the academic world to make many comments on the arising problems of the application of the EBITDA rule for partnerships: if partnerships are considered unitary businesses (see the case of the trade tax,)[67] it would seem suitable to consider partnerships as entities holding only one unitary business with the result that the participation in the partnership should be considered as a part of the overall equity held by the partner. Nonetheless, the academic world and the Ministry of

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[64] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); Lorenz Bernhard and Dieter Endres, supra note 59; Norbert Herzig and Alexander Bohn, *Modifizierte Zinsschranke und Pläne zur Unternehmensteuerreform 2008*, 1 DER BETRIEB 3 (2007); Stephan Kamphaus and Claus Loitz, *Jahresabschluss nach IFRS und Zinsschranke*, 60 DER BETRIEB 1261, 1266 (2007); *Stefan Köhler*, supra note 52; Ulrich Schreiber and Michael Overesch, *Reform der Unternehmensbesteuerung - Eine ökonomische Analyse aus Sicht der internationalen Besteuerung*, 813 DER BETRIEB 48 (2007).

[65] BMF-Schreiben, supra note 64; *Dorotee Hallerbach*, supra note 52, at 487; Sebastian Heintges and Christine Kamphaus and Rüdiger Loitz, *Jahresabschluss nach IFRS und Zinsschranke,* DER BETRIEB 1261 (2007); STAATS AND RENGER, DEUTSCHES STEUERRECHT (2007); NORBERT HERZIG, Der Betrieb 4 (2007).

[66] BMF-Schreiben, supra note 64.

[67] Ingo Van Lishaut and Andreas Schumacher and Peter Heinemann, *Besonderheiten der Zinsschranke bei Personengesellschaften*, DEUTSCHES STEUERRECHT 2341 (2008); RÖDDER, DEUTSCHES STEUERRECHT (2005).

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Finance have a completely different opinion[68] and consider the partnership as an entity separated from the partner itself.

The German Interest Barrier Rule is not designed in a neutral way concerning incorporation: this concerns profits from the participation in a partnership.[69] A sole trader could hold more than one participation in partnerships and consequently use the relevant portion of deductible interest for more than one participation.[70]

Concerning the exact definition of goods considered part of the business carried along through a partnership, the relevant definition comprehends not only the goods owned by the partnership but also those owned by the partners themselves and used for the economic activity of the partnership on a contractual basis, see Section 15, subsection 1 sentence 1 number 2 dEStG. This means that loans contracted in connection with distinct equity are to be seen jointly with the loans connected to the equity of the partnership itself.[71]

The result is that partnership are considered as distinct business, the calculation of the relevant interest barrier occurs that level.[72] For the purposes of the partner, a calculation of his overall profit is done, which is then again offset against the portion of deductible interest arising from the application of the barrier rule on the level of the partnership.

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[68]GUIDO FÖRSTER, in: VOLCKER BREITHECKER AND GUIDO FÖRSTER AND URSULA FÖRSTER AND RALF KLAPDOR (eds.), UNTERNEHMENSTEUERREFORM (2008); KORN, Kölner Steuerdialog 15880 (2008); URSULA LEY, DIE BESTEUERUNG DER PERSONENGESELLSCHAFTEN (2008).

[69] Stefan Köhler and Klaus Hahne, *BMF-Schreiben zur Anwendung der steuerlichen Zinsschranke und zur Gesellschafter-Fremdfinanzierung bei Kapitalgesellschaften*, 32 DEUTSCHES STEUERRECHT 1505 (2008).

[70] Ingo Van Lishaut and Andreas Schumacher and Peter Heinemann, *Besonderheiten der Zinsschranke bei Personengesellschaften*, supra note 69.

[71] Ralf Wagner, Hardy Fischer, *Anwendung der Zinsschranke bei Personengesellschaften*, 24 BETRIEBSBERATER 1811 (2007); Ingo Van Lishaut and Andreas Schumacher and Peter Heinemann, *Besonderheiten*, supra note 70.

[72] *URSULA LEY, IN DAI: DIE BESTEUERUNG DER PERSONENGESELLSCHAFTEN*, supra note 68; HEUERMANN, IN BLÜMICH, ESTG § 4H BETRIEBSAUSGABENABZUG FÜR ZINSAUFWENDUNGEN (2010).

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Concerning the determination of the relevant debt and linked interest expenses, which become reference to what is called "Harmful Shareholder Financing" (see infra), the academic world[73] believed that loans granted by different shareholders should not be summed, unlike to what was formerly applicable under the old version of Section 8a dKStG.

However, the relevant guidance of July 4th 2008 clarified that the remuneration of loans granted by shareholders must be all added up, no matter if those payments are linked to profits that the shareholder has earned in Germany or abroad.

The clarification is extended[74] stating that remunerations to persons closely related to qualified shareholders and those paid and to third persons with right of recourse against the previous mentioned persons have to be included in the calculation.

This has the consequence that the debt financings lent by all the shareholders have to be added together. It should be pointed out that the wording of the law could also lead to a separate calculation for each shareholder including persons related to him could.

The EBITDA rule itself has a different scope of application as the rule on "Harmful Shareholder Financing" provided for by Section 8a, subsection 2, dKStG. The general rule applies to all corporations while the special case of Section 8a, subsection 2 refers to shareholders holding at least 25% of the relevant equity. To sum up, the rule applies to limited companies (*AG*), limited liability companies (*GmbH*), limited partnerships with share capital (*KGaA*), societae europaea (*SE*), while cooperatives and other corporations, such as foundations or associations are excluded.

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[73] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); Michael Schaden and Daniel Käshammer, *Die Neuregelung des § 8a KStG im Rahmen der Zinsschranke*, 42 BETRIEBSBERATER 2260 (2007); Harald Dörfler and Ansald Wittkowski, *Anwendung der Zinsschranke, Verwaltungsanweisung*, BC Betrieb Rechnungswesen und Controlling 313 (2008).
[74] Johannes Huken, Entwurf eines BMF-Schreibens zur Zinsschranke, 11 Der Betrieb (2008); Hardy Fischer und Thomas Wagner, *Das BMF-Schreiben zur Zinsschranke – Überblick/Bewertung/Verbleibende Gestaltungen*, 35 Betriebsberater (2008).

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Closely Related Person

The notion of closely related person is given by Section 1, subsection 2, Aussensteuergesetz[75]; according to this provision, a related person is: 1) a person of whom, in this instance, the corporation holds directly or indirectly at least the 25% of the shares or on which the corporation exerts, directly or indirectly, a controlling influence, or, on the contrary, it is a person who holds a considerable share in the corporation or who, directly or indirectly, can exert a controlling influence on the corporation; or 2) is a third person who holds considerable shares or who can exert a controlling influence on the corporation or on its related person; 3) the person that, thanks to an agreement on the conditions of a business relationship regarding the corporation or its related person, is able to exert an influence on it or if one of them have an interest in the reach of profits.

The link to this definition is openly included in Section 8a, subsection 2, dKStG.

A person is considered as closely related to a tax payer, if it holds, directly or indirectly, at least 25% of the equity of the tax payer itself or it has the power to exercise, directly or indirectly, a controlling influence on the taxpayer.

The same applies in the opposite case: a person is deemed closely related to a tax payer if the tax payer holds a direct or indirect qualified shareholding in the related person or if he has the power to control it; the most complicated structure is the one where a third party is related to a tax payer controlling directly or indirectly or being controlled directly or indirectly by a company.[76]

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[75] Aussensteuergesetz, German Foreign Tax Act, officially cited as *Außensteuergesetz vom 8. September 1972 (BGBl. I S. 1713), das zuletzt durch Artikel 7 des Gesetzes vom 8. Dezember 2010 (BGBl. I S. 1768) geändert worden ist*; from now on AStG.
[76] Michael Schaden and Daniel Käshammer, *Die Neuregelung des § 8a KStG im Rahmen der Zinsschranke*, 42 BETRIEBSBERATER 2260 (2007).

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Third Person with Right of Recourse

A notion that becomes quite significant in the matter of shareholder financing is the one referred to “third parties with the right of recourse”: starting from a definition provided for by Civil Law,[77] it intends situations where a person is liable, with money or other assets, for the debt of another person, on the basis of a valid right. The use of this concept for the purposes of Tax Law is broader though: where, in Civil Law, it would be limited to cases in which the shareholder or a person closely related to him gives a guarantee statement (*Bürgschaftserklärung*) or makes a guarantee deposit (*haftende Einlage*) at least equal to the amount of the relevant debt financing, the relevant tax authority guidance[78] states that the expression “that can make recourse” is intended to be applicable for all those cases in which the shareholder or the person closely related to him were *de facto* liable for the reimbursement of the company debt. This is not dependent by existing concrete and legal rights.

One could think that this has the consequence of the existence of an automatic right of recourse against the parent company in the case of economic groups[79] but this has been rejected by the majority of academics.
The same interpretation was later accepted by the Tax Administration,[80] that accepted the interpretation given by German Civil Law and by Guidance of July 22nd of 2005 limited the notion of recourse to cases of back-to-back financing.[81]

Also the actual provision of Section 8a dKStG after the amnedments put in place through the last tax reform includes the concept of “ right of recourse” This is certainly done to prevent harmful tax designs established in order to escape the EBITDA rule itself as the intention of the rule itself is to dispose of a broader and more stable tax base.[82]

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[77] The relative discipline is contained in Sec. 43 WechselG and Sec. 40 ScheckG.
[78] BMF-Schreiben, supra note 64.
[79] For example: GERRIT FROTSCHER, §8A KSTG A.F., (2006), BROER BLÜMICH, ESTG, KSTG, GEWSTG (2006).
[80] BMF-Schreiben, supra note 64.
[81] BMF-Schreiben vom 22. Juli 2005 IV B 7 - S 2742a - 31/05.
[82] BT- Drs. 16/4841, p. 59 ff., 68, 82.

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Coherently to what was applicable before, it seems that the law should refer to those situations in which the shareholder or a person closely related to him *de facto* guarantees the reimbursement of the debt to the lender. This means that there is no necessity of written agreements.[83]

It is easily understandable that this new version of the concept of "right of recourse" is broader than the one applicable before because of its "factual" nature, it is certainly the case that, being applicable to all situation substantively understandable as right of recourse, it has a scope of application much broader than the one applicable before.[84]

As this circumstance make the application of the EBITDA rule more dangerous particularly for those companies in financial struggles,[85] in which it is coomon sense that a shareholder grants certain guarantees with reference to the loans contracted by his company and as this circumstance would have a strong impact on the possibility of turnaround of companies, some academics[86] suggest to apply Section 8a dKStG only in cases of real back-to-back financings.

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[83] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); Stefan Eilers, *Fremdfinanzierung im Unternehmen nach der Unternehmensteuerreform* 15 FINANZRUNDSCHAU 733 (2007); Heinz Kuβmaul and Christoph Ruiner and Christian Schappe, *Auswirkungen der Unternehmensteuerreform 2008 auf den Mittelstand,* GMBHR 514 (2008); Ulrich Prinz, *Zinsschranke und Organisationsstruktur: Rechtsformübergreifend, aber nicht rechtsformneutral anwendbar,* 8 DER BETRIEB 368 (2008).

[84] BT-Drs. 16/4841, p.133; WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); JENS BLUMENBERG AND FLORIAN LECHNER IN JENS BLUMENBERG and SEBASTIAN BENZ, DIE UNTERNEHMENSSTEUERREFORM 2008 – ERLÄUTERUNGEN UND GESTALTUNGSHINWEISE (2007); Karsten Ganssauge and Oliver Mattern, *Der Eigenkapitaltest im Rahmen der Zinsschranke*, 46 DEUTSCHES STEUERRECHT 213 (2008); Siegfried Grotherr, *Funktionsweise und Zweifelsfragen zur neuen Zinsschranke 2008,* 14 INTERNATIONALE WIRTSCHAFTSBRIEFE 1489 (2007); *Dorotee Hallerbach*, supra note 52; Johanna Hey, *Verletzung fundamentaler Besteuerungsprinzipien durch die Gegenfinanzierungsmaßnahmen des Unternehmensteuerreformgesetzes,* BETRIEBSBERATER 1303 (2007); *Johannes Huken*, supra note 74; *Stefan Köhler*, supra note 52, at 597; Gert Müller-Gatermann, *Unternehmenssteuerrfeorm 2008* in *Die Steuerberatung 2007,* STEUERN UND BETRIEB 145 (2008); REICHE, KROCHEWSKI, DEUTSCHES STEUERRECHT 1330 (2007); *Thomas Rödder and Ingo Stangl*, supra note 52; MICHAEL SCHADEN AND DANIEL KÄSHAMMER, DIE UNTERNHEMENSTEUERREFORM (2008); Thomas Töben and Hardy Fischer, *Zinsschranke - Regelungskonzept und offene Fragen*, 18 BETRIEBSBERATER 974 (2007).

[85] Michael Schaden and Daniel Käshammer, *Die Neuregelung des § 8a KStG im Rahmen der Zinsschranke*, 42 BETRIEBSBERATER 2260 (2007).

[86] Michael Schaden and Daniel Käshammer, supra no. 83, at 2261.

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<u>The basic notion of Fiscal EBITDA</u>

The basic rule of the German EBITDA rule is contained in the Personal Income Tax Act (EStG), in Section 4, subsection 1, dEStG. It consists in a limitation of interest deduction based on the entity´s profit. The first limitation concerns the balance of interest payments: interest is fully deductible if the balance between received and paid interest is higher than zero.

The next step is the calculation of the relevant fiscal EBITDA: starting from the profit of the relevant fiscal year, interest income is subtracted, depreciation are added as well as amortizations and interest expenses.

This kind of EBITDA represents the basis for the calculation of the relevant portion of interest deemed deductible. The portion of EBITDA relevant for the determination of the amount of deductible interest is equal to 30%. Amounts of the interest balance higher than that aforementioned portion of EBITDA can be carried forward.

Obviously, the relevant EBITDA is of fiscal nature and, different from what is known from accounting, has to be determinded according to fiscal principles: this means that the starting point is the taxble income determined by fiscal principles and that the aforementioned variations are put in place by use of the amounts determined by tax principles themselves. The deduction of interest payments represents the last variation that must be applied to profit in order to obtain relevant EBITDA.

For the case of partnership, although the logic of the approach is identical, reference is made to the determination of income and not to profit: the tax authority guidance of 4th July 2008 states that the determination of fiscal EBITDA starts with the calculation of the taxable profit before the application of

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the EBITDA rule and the consequent subtraction of net interest expenses and the deductions of Section 6, subsections 2 and 2a dEStG and Section 7 dEStG.[87]

For corporations, particular cases concerning the calculation of fiscal EBITDA, still based on taxable profits,[88] are expenses and deductions according to Section 6, subsection 2 and 2a as well as Section 7 dEStG and carry-forward and carry-back of losses pursuant to Section 10d dEStG and deductions for donations in accordance with Section 9, subsection 1, 1 No. 2 dKStG which have to be added.

The problem arising from the fact that the legal provision makes reference to the term "income" and "profit" is referred to the inclusion or not of relevant hidden profit distributions.[89] Corporate Tax Guideline 29[90] clarifies this point as it is not important what the basic term is as both allow the inclusion of hidden profit distributions. It is clear where this different use of legal terms comes from: in the case of corporation the use of the term income, which means income for tax purposes does not lead to problems. Different is the case of partnership which, being transparent with reference to the income of their shareholders, do not present own income but only profits. As the legislator had the intention to consider the relevant "income" of the partnership itself and not the one of the partner, it becomes quite clear why a different term was used.

The income of a corporation is calculated by application of Section 8a, subsection 1, 2 dEStG. The calculation of the relevant basis for the application of the EBITDA rule, i.e. fiscal EBITDA, is put in place by subtracting the amount of received dividends and by the profits arising from disposals and increased by the amount of hidden distributions of profit.

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[87] Decrease of the value of goods pursuant to Section 6, subsection 2 dEStG, eliminations of general items (*Sammelpostens*) pursuant to Section 6, subsection 2, a) dEStG and to consumption or deterioration pursuant to Section 7 dEStG.
[88] Hidden profit distributions increase the relevant profit as stated by BT-Drs. 16/4841 S. 74).
[89] ROLF SCHWEDELM in MICHAEL STRECK, KSTG KOMMENTAR (2010).
[90] Körperschaftssteuerrichtlinien, General Guidance on Corporate Income Tax, Allgemeine Verwaltungsvorschrift zur Körperschaftsteuer vom 13. Dezember 2004 (BStBl I Sondernummer 2/2004).

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Permanent establishments in Germany, held by non-resident entities, bear special rules: the relevant interest expenses become relevant only with reference to the interest expenses really borne by the permanent establishment. This because of the circumstance that foreign mother and permanent establishment are seen as one unitary business with reference to the German EBITDA rule. If it is the case that the relevant capital used by the permanent establishment is redetermined by the tax administration by means of the rules for permanent establishments,[91] the relevant portion of equity tracks the portion of deductible interest and consequently modifies the relevant EBITDA.[92]

Tax authority guidance of 4th July 2008 clarifies that the fiscal EBITDA should be determined with reference to the company, therefore, as emphasized before, interest expenses, revenues, tax write-offs as well as profit sharing have to be taken into account at the partnership's level and not at the one of the partner.

It seems important that this is clarified as, in the opposite case, cascade effects could be put in place: in cases of multi-level commercial partnerships dividends could be transferred to a company at a lower level into the profits of a company at a higher level. This would result in an EBITDA duplicatet or at least increased. It has to be stated that the solution suggested by the tax authority guidance goes beyond the wording of Section 4h dEStG and Section 8a dKStG.

Partners holding their share in a partnership through an asset management company (*Zebragesellschaft*) are directly subjected to the EBITDA rule at their level to avoid the aforementioned cascade-effect.

Fiscal units are treated as one unitary business for the purposes of the EBITDA rule: the tax authority states that interest expenses and revenues, as well as the dividends of a company that is part of the group, have to be consolidated at the level of the controlling company.

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[91] BMF - Schreiben vom 25.08.2009 and Betriebsstättenerlass vom 24.12.1999.

[92] SIEGFRIED GLUTSCH, INES OTTE, BERND SCHULT, DAS NEUE UNTERNEHMENSTEUERRECHT: RICHTIG BERATEN NACH DER ZINSSCHRANKE 170 (2008).

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Continuing with anti-avoidance provisions, if there are changes of more than 25 per cent of the shareholders, the carry-forward of the relevant EBITDA is cancelled in proportion. When the relevant changes concern more than 50 per cent of the shareholders, the carry-forward is completely cancelled.[93]

Multi-Level Partnerships

Some doubts arise in the case of partnerships controlled again by a partnership (a design typical for German tax planning by the way). The main doubt concerns the treatment of the profit realized by the controlled partnership with reference to the application of the EBITDA rule referred to the controlling partnership.[94]

See from a dormal point of view, a profit realized by a partnership again controlled by another partnership should have no influence with regard to the calculation of the relevant fiscal EBITDA at the level of the controlling partnership according to Section 4, subsection 1, dEStG.

Some doubts arise because of two judgement by tax courts,[95] which, under the old rule, stated that the profit determination of the controlling partnership should have its starting point in the profit of the controlled partnership due to the principle of transparency of partnerships.

The tax authority adopts a different opinion and uses the formal wording of Section 4, subsection 1, dEStG, with the result that the fiscal EBITDA of the controlling partnership is determined without taking the portion of profits deriving from the subsidiary partnership into consideration. Also corporations holding partnerships should be treated the same way. This from a formal point

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[93] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011); Götz Wiese, *§ 8 Abs. 4 KStG im Regelungssystem des Verlustausgleichs*, DEUTSCHES STEUERRECHT 741 (2007); Thomas Beußer, *Die Verlustabzugsbeschränkung gem. § 8c KStG im Unternehmensteuerreformgesetz 2008*, 29 DER BETRIEB 1549 (2007).
[94] Heinz Kuβmaul and Armin Pfirmann and Stefan Meyering and Rene Schäfer, *Ausgewählte Anwendungsprobleme der Zinsschranke*, 4 BETRIEBSBERATER 135 (2008).
[95] BFH, 11.12.2003 – IV R 42/02, BStBl; BFH, 26.1.1995 – IV R 23/93,BStBl.

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of view means that profits deriving from partnerships don´t have to be considered in the calculation of the relevant fiscal EBITDA of a corporation.

As seen above, Section 8a, subsection 1, dKStG, makes reference to the relevant profit of an entity and not to its income has to be taken into account. Based on this consideration, it appears clear that the view given by the Tax Administration is the one to follow:[96] profits received by corporation originating from the control of a partnership assume relevance for the calculation of the respective fiscal EBITDA.

Nonetheless, such an opinion has to be considered in the context of Section 4, subsection 4a, dEStG: as stated before, in cases of multi-level partnership the calculation of the relevant fiscal EBITDA starts from zero again when elevating to the next level of control.

This of course leads to many possibilities of tax planning as, by transformation into a partnership, there is the possibility to design the size of the relevant fiscal EBITDA within economic groups.[97]

c. Safeguard clauses

Safeguard clause are included in Section 4, subsection 2, dEStG: those exclusions are alternative and lead to cases where the deduction of interest expenses is not limited. Companies can fully deduct their interest expenses if, first, the interest balance is lower than 1 Million €; secondly, the company does not belong to a group of companies and thirdly, the ratio of equity of the company is not lower than 1% compared to the overall ratio of the whole group.

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[96] Heinz Kussmaul and Michael Zabel: *Auswirkungen der Änderungen der §§ 8b und 15 KSTG durch das Gesetz zur Umsetzung der Protokollerklärung der Bundesregierung zur Vermittlungsempfehlung zum Steuervergünstigungsabbaugesetz („Korb II")*, 11 BETRIEBSBERATER 5 (2004).
[97] *Heinz Kußmaul and Armin Pfirmann and Stefan Meyering and Rene Schäfer*, supra note 90, at 136.

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Gross 1 Million € Limit

The EBITDA rule does not apply if gross interest payments are below 1 Million € according to Section 4, subsection 2, 1, a) dEStG,. This exclusion has to the nature of a bare threshold: no ban to use this exclusion is provided. This means that it can be used by every kind of company, also by those that belong to a group.
The relevant tax authority guidance[98] clarifies that the limit refers to each financial year and that interest payments carried forward from previous fiscal years need to be included.[99]

This makes the rule applicable only to companies with a high amount of debt financing: consider an average interest rate equal to 5%, this would lead to a gross amount deemed acceptable of 20 million Euros. We see that the rule does not have the intention to penailize small companies but has its aim in ruling with respect to companies at least medium sized.[100]

As stated before, a group tax consolidation has to be considered as a single business to the EBITDA rule purposes according to Section 15, subsection 3, 2 dKStG. Therefore, the 1 Million € limit applies to the whole fiscal group.

During the economic crisis of years 2008 and 2009, the limit was raised to 3 million;[101] the limit was consequently raised retroactively starting from the date of introduction of the provision itself.[102]

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[98] BMF-Schreiben, supra note 64.
[99] EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT, DIE KÖRPERSCHAFTSTEUER, KOMMENTAR ZUM KÖRPERSCHAFTSTEUERGESETZ 116 (2007); *GUIDO FÖRSTER in VOLKER BREITHECKER, GUIDO FÖRSTER, URSULA FÖRSTER, RALF KLAPDOR,* supra note 67; *Johannes Huken*, supra note 74; Siegfried Grotherr, *Funktionsweise und Zweifelsfragen zur neuen Zinsschranke 2008,* 14 INTERNATIONALE WIRTSCHAFTSBRIEFE 1489 (2007); Ulrich Prinz,: *Mittelstandsfinanzierung in Zeiten der Zinsschranke*, 10 FINANZRUNDSCHAU 441 (2008).
[100] *Stefan Köhler*, supra note 52, at 598.
[101] Wolfgang Kessler and Marie-Louise Dietrich, *Die Zinsschranke nach dem WaBeschG - la dolce vita o il dolce far niente?* 5 DER BETRIEB 15, 21 (2010); Christine Hoffmann, *Zinsschranke – Gibt es die Freigrenze noch?* DEUTSCHES STEUERRECHT 1461 (2009).

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Stand-alone Clause

The EBITDA rule does not apply if the company does not belong to a group of companies. Section 4h, subsection 3, 5 – 6 dEStG gives an extended notion of association to a group: a company is considered part of an economic group not only if it is included in its consolidated financial accounts but also if its economic and business decisions are decided at the group

What is relevant in this respect is that the affiliation to the group doesn´t have to be formally implemented: the simple possibility to opt for the group tax consolidation seems to be enough to state the company is part of a group.[103]

"Escape Clause"

According to what was stated before, a company belonging to a group is excluded from the application of EBITDA rule in accordance with Section 4h, subsection 2, 1 c) dEStG.
The relevant interest is consequently deductible. This applies only with the limitation that the the equity ratio of the given group company can´t be lower than the equity ratio referred to the whole group with a variation of at least 1%.

The relevant equity ratios start from the consolidated financial statements referred to the previous fiscal year according to Section 4h, II c) dEStG.

The business year of the relevant financial statements must be considered as it was the same for the whole group. The relevant guidance states that if the examined company presents a different fiscal year, the relevant equity ratio has to be calculated with reference to the financial statements of the last available full year.[104]

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[102] EWALD DÖTSCH AND WERNER JOST supra note 100; *Roland Fischer and Thomas Wagner*, supra note 75, at 2627.
[103] BMF-Schreiben, supra note 64.
[104] BMF-Schreiben, supra note 64.

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Accounting standards adopted should be the same for all compared companies. Expressly, Section 4h, subsection 2, 1 c), sent. 8 dEStG states that the financial statements used to calculate the equity ratios must be drafted in accordance with IFRS.
This is not compulsory if the consolidated financial statements do not have to be drafted in accordance with IFRS, if they do not have to be published and if they have not been drafted in accordance with IFRS in the last five years.
A special case concerns companies keeping books according to US-GAAP: these principles are accepted for purposes of the equity ratio calculation. [105]

The equity ratio of the company is calculated considering the company's goodwill for the part booked in the consolidated financial statements and 50% of special tax reserves (*Sonderposten mit Rücklagenanteil*) must be added to the equity capital in accordance with Section 4h, subsection 2, 1 c) 5 dEStG.[106]

There is then a series of modifications to be applied to the amount of book equity: the participations in other group members is discounted, the capital contributions made in the last six months of the business year are subtracted if they correspond to distributions or withdrawals made in the same period and participations that do not confer voting rights, except from preferred shares, are subtracted.

Accounts receivable not reported in the consolidated financial statements of the group insofar as they correspond to accounts payable are also cancelled. The

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[105] Harald Dörfler and Andreas Vogl, *Unternehmenssteuerreform 2008: Auswirkung der geplanten Zinsschranke anhand ausgewählter Beispiele*, 20 BETRIEBSBERATER 1084 (2007); Hardy Fischer und Thomas Wagner, *Das BMF-Schreiben zur Zinsschranke – Überblick/Bewertung/Verbleibende Gestaltungen*, 35 Betriebsberater 1877 (2008); *GUIDO FÖRSTER IN VOLKER BREITHECKER, GUIDO FÖRSTER, URSULA FÖRSTER, RALF KLAPDOR,* supra note 67; Joachim Hennrichs, *Zinsschranke, Eigenkapitalvergleich und IFRS*, DER BETRIEB 2101 (2007); *Johannes Huken*, supra note 74, at 544; Norbert Lüdenbach, Wolf-Dieter Hoffmann, *Der IFRS – Konzernabschluss als Bestandtel der Steuerbemessungsgrundlage für die Zinsschranke nach § 4h EStG-E*, 14 DEUTSCHES STEUERRECHT 636 (2007); *Stefan Köhler*, supra note 52, at 604; *Stefan Köhler and Klaus Hahne*, supra note 68, at 1514; *Heinz Kußmaul and Armin Pfirmann and Stefan Meyering and Rene Schäfer*, supra note 90, at 140; SCHWEDELM ROLF IN: STRECK MICHAEL, supra note 87, at §8a KStG, note 59.
[106] SCHWEDELM ROLF IN: STRECK MICHAEL, supra note 87, at §8a KStG, note 59.

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same is applicable for outside capital, that other companies affiliated to the group have put at the company's disposal: is not included in the equity ratio of the company.
Partnerships have to include all special business assets in the business of the partner for the relevant equity ratio calculation according to Section 4h, subsection 2, 1 c), 7 dEStG. This to counteract elusive tax arrangements.[107]
This has been put in place to counteract hidden debt financing provided for by one of the partners. The wording of the rule is, on the other hand, quite unclear and makes different approaches possible.[108]

Bans to the Use of the Escape Clauses

The system for exclusions concerning the general limitation provided for by the EBITDA rule is multilevel: certain exclusions are not applicable if, again, certain conditions are not met after it has been explored that the general exclusion would be prima facie applicable: these are the so called bans to use exclusion clauses.[109]

As seen before the *Stand-alone clause* determines that the EBITDA rule does not apply companies not being consolidated with other companies within a group of companies.

The ban to use this escape clause is designed as follows: according to Section 8a, subsection 2, dKStG, a company is not allowed to make use of this

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[107] Official explanatory note to the draft bill: BT-Drucks note 16/4841, note 27.
[108] EWALD DÖTSCH AND WERNER JOST supra note 100; *JENS BLUMENBERG AND FLORIAN LECHNER,* supra note 82, at 167; *Harald Dörfler and Andreas Vogl,* supra note 99, at 1084; Heinz Kuβmaul and Christoph Ruiner and Christian Schappe, *Probleme bei der Ermittlung der Körperschaftsteuererhöhung im Rahmen von § 38 Abs. 2 KStG*, 19 DEUTSCHES STEUERRECHT 904, 909 (2008); Schwedelm Rolf, *Die neue Zinsschranke für Personen- und KapGes*, 6 GMBH-STB 282 (2007); Hardy Fischer and Thomas Wagner, 1815.
[109] Fabian Schmitz-Herscheidt, *Zinsschranke und Gesellschafterfremdfinanzierung bei nachgeordneten Mitunternehmerschaften,* 14 BETRIEBSBERATER 700 (2008); *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT,* supra note 94, at 116, 117; 1514 *Heinz Kuβmaul and Armin Pfirmann and Stefan Meyering and Rene Schäfer,* supra note 90, at 136.

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safeguard clause only if financed by harmful debt. This means that the company has to prove that at least 90% of its relevant interest is not referred to shareholder financing of controlling perons with a participation higher than 25%, or to a person related to such a shareholder. [110]

Seen the other way round, a corporation is considered financed harmfully if one or more shareholders holding more than the 25% of the share capital directly or indirectly, a person closely related to them, a third person with right of recourse against them receive more than 10% of the interest payments.[111]

In accordance to Section 8a, subsection 3 dKStG, a German company part of an international group with a strong equity ratio cannot make use of the *Escape Clause* if any foreign group company, has received harmful shareholder financing.[112] This appears to go clearly beyond the initial intentions of the German legislator.

It appears quite simple how this ban could be taken over: the financing should be given to the German company, which has a higher EBITDA and which can deduct the interest expenses. Afterwards the German company could lend the money to the foreign company, as financings within the group do not have any relevance to Section 8a, subsection 3, dKStG purposes.[113]

Internal group financing is not touched by the aforementioned ban according to Section 8a subsection 3, 2 dKStG.

Section 4h subsection 2, 2 dEStG makes the bans provided by Section 8a subsection 3, 2 and subsection 3 dKStG applicable to those partnerships directly

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[110] WALTER BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR (2011);Michael Schaden and Daniel Käshammer, *Der Zinsvortrag im Rahmen der Regelungen zur Zinsschranke*, 43 BETRIEBSBERATER 2317 (2007).
[111] *Michael Schaden and Daniel Käshammer*, supra note 103, at 2261; *STRECK MICHAEL*, supra note 87, at 324.
[112] *Michael Schaden and Daniel Käshammer*, supra note 103, at 2264.
[113] *Michael Schaden and Daniel Käshammer*, supra note 103, at 2264.

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or indirectly controlled by corporations. Again, asset management partnerships are not included within the scope of application of the rule.[114]

It is not clear in this respect, what minimum participation is requested for the application of the aforementioned ban with respect to partnerships. The formerly applicable thin capitalization provision used a general minimum participation of 25%, applicable both for corporations as well as for partnerships,[115] the new version of Section 4h, subsection 3, 2 dEStG does not expressly include a minimal shareholding.
This results in two possibilities: the first is the one of including any partnership controlled by means of more than 25% equity holding in the scope of the ban.[116] The second is to state that no minimum participation is requested in this respect.[117] It hasn´t been clarified by the German Tax Administration which of the two possible approaches is the correct one.

Application of Section 8a subsection 2, dKStG to Partnerships

It remains unclear how shareholding partnerships shall be treated for the purposes of the ban to use the escape clause provided for by Section 8a subsection 2, dKStG. We have seen that Section 4h subsection 2, 2 dEStG states the "correspondent" application of Section 8a, subsection 2 dKStG to partnerships.

For what we stated afore, with reference to corporations controlling partnerships, the relevant Section 8a, subsection 2 dKStG, is applicable to this

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[114] *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 101; PATT JOACHIM IN: DÖTSCH EWALD ANS JOST WERNER AND PUNG JOACHIM AND WITT GEORG, DIE KÖRPERSCHAFTSTEUER, (2008), § 20 UmwStG (SEStEG), N. 116; *Heinz Kußmaul and Armin Pfirmann and Stefan Meyering and Rene Schäfer*, supra note 90, at 135 ff.; *Fabian Schmitz-Herscheidt*, supra note 102, at 699; Hardy Fischer und Thomas Wagner, 1812.
[115] Section 8a, subsection 5 dKStG version of 2003.
[116] INGO STANGL, JENS HAGEBÖCKE IN SCHAUMBURG RÖDDER, UNTERNEHMENSTEUERREFORM 468 (2008).
[117] *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 101; *Roland Bien and Thomas Wagner*, supra note 70, at 1812; *Fabian Schmitz-Herscheidt*, supra note 102, at 700.

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case by substituting the word "corporation" with the word "partnership".[118] This leads to the rule that the relevant remunerations in this respect are those paid by the partnership pays.[119]

For the case matter of analysis in this chapter it has to be clarified whether the "correspondent application" of Section 8a subsection 2 dKStG refers also to the word "shareholder". This, finally, would mean that all the compensations that the partnership pays to any qualified partner, to a person closely related to it or to a third person with right of recourse against it, have to be considered for the purposes of Section 8a subsection 2 dKStG.

The alternative could be to consider only payments made to corporations by intending the "correspondent application" referring only to the word "corporation".[120]
This second interpretation would obviously lead to open doors for tax planning as a shareholder of a corporation could grant a loan to a subsidiary partnership of its corporation and Section 8a dKStG would not apply with the consequence that the relevant interest paid to the shareholder by the partnership would not constitute special business income, as it is paid not to the partner (the corporation), but to the shareholder of the corporation.

The most balance solution would be to apply the rule to any kind of shareholder no matter what his legal personality is like but under the condition that its participation is qualified, Section 4h subsection 2, 2 dEStG should apply only if

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[118] Hardy Fischer und Thomas Wagner, 1812; *Michael Schaden and Daniel Käshammer*, supra note 103, at 1262; *Fabian Schmitz-Herscheidt*, supra note 102, at 701.
[119] EWALD DÖTSCH AND WERNER JOST supra note 100; Thomas Töben and Hardy Fischer, *Die Zinsschranke – Regelungskonzept und offene Fragen*, 18 BETRIEBSBERATER 974 (2007).
1812 *Fabian Schmitz-Herscheidt*, supra note 102, at 701.
[120] *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 102; *Michael Schaden and Daniel Käshammer*, supra note 103, at 2264; INGO STANGL and JENS HAGEBÖCKE, IN: SCHAUMBURG, RÖDDER, UNTERNEHMENSTEUERREFORM 501 (2008).

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interest is paid to a qualified shareholder of the corporation, to a person closely related to him or to a third person with recourse against them.[121]

Interest and similar income

Two basic elements have to be met for the definition of interest according to Section 4h, subsection 2, 2 dEStG: interest consists in the remuneration for a loan and reduces the relevant taxable income. The relevant guidance issued by the Ministry of Finance[122] states that all contributions not definable as equity under commercial law have to be considered as interest relevant for the purposes of the German EBITDA rule.

Section 233 KStR states that expenses and revenues related to debt with indefinite amount and subordinated to uncertain events also need to be included. Moreover it is stated that the rule does not apply to commercial discounts, reimbursements withheld or refunds related to insurance contracts that are transferred to reserves.
The definition of interest in this respect includes interest relative to fixed or variable interest coupons as well as particular profit sharing agreements (*i.e.* compensations relative to silent partnerships, to enjoyment rights and to profit debenture bonds) and revenue sharing.

If a payment does not have the nature of interest but is paid to the lender of a debt financing, it has to be included in the amount of relevant interest. This applies for premiums, discounts, compensations due to incidents, fees and commissions. This because of their substitutive nature.

The sale of a certain credit leads to the assumption that the profit margin resulting from the difference between the nominal value of the credit and the sale price has to be included within the relevant category of interest. The cost

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[121] *Fabian Schmitz-Herscheidt*, supra note 102, at 699; *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 101; *Michael Schaden and Daniel Käshammer*, supra note 103, at 2261; *Fabian Schmitz-Herscheidt*, supra note 102, at 703.
[122] BMF-Schreiben, supra note 64.

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for covenants referred to certain loans are not to be included within the category of interest. Fees connected with the subscription of loans such as arrangement fees and similar are not included in the relevant category according to the cited guidance.[123]

Non-deductible interest expenses at the level of the company are not taken into account. Interest payments partially deductible or to be qualified as special compensations are excluded from the scope of application of the rules in accordance with Section 15, I dEStG.

In the calculation of the relevant amount of interest, the amounts resulting from the application of the rule itself, although not representing profit distributions are nonetheless not considered as interest payments (see Section 3, Subsection 1 and 2 dEStG with Section 4, subsections 4a and 5 with subsection 1, No. 8 dEStG with Section 8, subsection 2, 2 dKStG).

The law itself does not contain specific rules concerning leases as the relevant tax authority guidance[124] of 4th July 2008 (No. 25 – 26) delivers exhaustive details in this respect.

What is applicable is a "substance over form" approach: the interest portions of the leasing rates are to be taken into account if the considered good is transferred to the lessee.

d. Carry-forward of non-deductible interest

Interest payments deemed non-deductible because of the application of the EBITDA rule can be carried forward and added to those of the next fiscal year without increase of the relevant income according to Section 4 dEStG.

As the wording of the law is not precise, carried forward interest is treated as it had arisen in the following fiscal year and consequently deemed as part of the

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[123] BMF-Schreiben, supra note 64.
[124] BMF-Schreiben, supra note 64.

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interest expenses of the same year.[125] This leads to significant problems if the relevant carried forward interest is again deemed non-deductible because of the fact that the relevant portion of the next fiscal year´s EBITDA is not big enough to include it among deductible expenses.

The consequence would be an interest amount slowly growing over years, always non-deductible because of the amount of the relevant EBITDA portion, finally leading finally to a violation of the bare 1 million Euro limit. This problem is passed over by a statement of the relevant Tax Authority guidance which accepts interest deductions for carried forward interest even if the condition of the Bare One Million Euro Escape Clause is not respected.[126] Although stated by part of the academic world,[127] the same is not Applicable with reference to the other conditions of exclusion from the EBITDA rule: carried forward interest is not explicitly excluded.

Special rules apply for the documentation of the relevant carried forward interest.[128]

A sale of the relevant entity leads to the final cancellation of the right to carry forward non-deducted interest (see Section 4h, subsection 5, dEStG).

A similar rational is underlying the rule according to which in the case of the exit of a partner from a partnership, the relevant portion of interest, determined in proportion to the participation of the partner in the entity´s equity, is definitely cancelled according to Section 4h, subsection 5, 2 dEStG.[129]

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[125] THOMAS EISGRUBER, HANDBUCH UNTERNEHMENSSTEUERREFORM (2008) 84.
[126] BMF-Schreiben, supra note 64.
[127] *Johannes Huken*, supra note 74, at 546; *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 116; *Siegfried Grotherr*, supra note 94, at 1489; *GUIDO FÖRSTER IN VOLKER BREITHECKER, GUIDO FÖRSTER, URSULA FÖRSTER, RALF KLAPDOR*, supra note 67, at 118.
[128] BMF-Schreiben, supra note 64.
[129] *Stefan Köhler*, supra note 52, at 604; *Stefan Köhler and Klaus Hahne*, supra note 68, at 1512; EWALD DÖTSCH AND WERNER JOST supra note 100; *Michael Schaden and Daniel Käshammer*, supra note 103, at 2320; *Heinz Kußmaul and Christoph Ruiner and Christian Schappe*, supra note 101, at 904.

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Even though the law does not list any additional case, the relevant tax authority guidance[130] states that the portion of carried forward interest lost is only the one referable to the selling shareholder itself.[131]

The provisions of Section 4h dEStG are not applicable for companies part of a fiscal unit according to Section 15, subsection 3 dKStG. As stated before, for the purposes of the EBITDA rule, the controlling entity and the whole group have to be considered as one unitary business with a consequent calculation of the relevant EITDA rule only on the level of the controlling entity. This should lead to the rule that gives no relevance to the exit of one of the group companies from the fiscal unit with reference to non-deductible interest carried forward.[132]

However, tax authority determines the identity of the exit from a fiscal unit and the partial sale of a company through the exit of a shareholder: the carried forward interest relative to that company is lost.[133] This is valid also for the case of mergers and other reorganizations: carried forward interest expenses cannot be transferred, both in the case of mergers and conversion of a corporation into a partnership according to Section 12, subsection 3 Umwandlungssteuergesetz[134] with Section 4, subsection 2, 2 UmwStG.

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[130] BMF-Schreiben, supra note 64.

[131] *Roland Fischer and Thomas Wagner*, supra note 75, at 1875.

[132] *Roland Fischer and Thomas Wagner*, supra note 75, at 1875; Norbert Herzig and Bernhard Liekenbrock, *Zinsschranke im Organkreis*, DER BETRIEB (2007) 2391; *Michael Schaden and Daniel Käshammer,* supra note 103, at 2320.

[133] *Roland Fischer and Thomas Wagner*, supra note 75, at 1875; *Johannes Huken*, supra note 74, at 546; *Stefan Köhler*, supra note 52, at 604; *Stefan Köhler and Klaus Hahne*, supra note 68, at 1513.

[134] Umwandlungssteuergesetz, Reorganization Tax Act, officially cited as Umwandlungssteuergesetz vom 7. Dezember 2006 (BGBl. I S. 2782, 2791), das zuletzt durch Artikel 4 des Gesetzes vom 22. Dezember 2009 (BGBl. I S. 3950) geändert worden ist, from now on UmwStG; *Michael Schaden and Daniel Käshammer*, supra note 103, at 2321; *Eickhorst, BB*, supra note 32, at 1709; *Dorotee Hallerbach*, supra note 52, at 293; *Thomas Rödder and Ingo Stangl*, supra note 52, at 480.

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Attribution of non-deductible interest to group members

It has been stated before, that in the case of fiscal units or fiscal groups, the relevant amount of interest is calculated only at the level of the controlling company after a sum, on this level, of all relevant interest amounts referred to the single group companies,[135] non-deductible interest allowed to be carried forward is also determined at this level of the fiscal unit.

If the relevant fiscal unit is no longer existing due to cancellation of the relevant contracts, the interest that can be carried forward is conserved at at the level of the controlling entity and is not lost, since the entity that controlled the fiscal group continues to carry out its activities.[136]

To become part of a fiscal unit is not considered a harmful event and consequently there is no penalization of companies becoming part of a fiscal unit during a fiscal year: the relevant amount of interest allowed to be carried forward held by the entering company is not deemed lost.[137] The general acceptance does not reach the point of an allowance to use this carried forward interest in the tax management of the fiscal unit: the relevant amount of interest carried forward and brought into the the group by a new group member is simply *frozen* which means that it cannot be used during the permanence within the fiscal group, neither by the holder of the interest itself nor by the holding company of the group, according to Section 15, I Nr. 3 dKStG and Section 4h, I, 2 – 3 dEStG.

[135] According to Section 14, subsection 1, the holding company, called *Organträger* is the entity liable for all tax matters of the fiscal unit with particular reference to the calculation of the tax due and the payment of the taxes themselves. See Norbert Herzig and Bernhard Liekenbrock, *Zinsschranke im Organkreis, Systematisierung und Analyse der gesetzlichen Neuerungen* 44 DER BETRIEB 2387 (2395); Norbert Herzig and Bernhard Liekenbrock, *Zinsvortrag bei Organschaft*, 37 DER BETRIEB 1949, 1956 (2009).

[136] Norbert Herzig and Bernhard Liekenbrock, *Zinsvortrag bei Organschaft*, 37 DER BETRIEB 1949, 1956 (2009); MICHAEL SCHADEN AND DANIEL KÄSHAMMER, supra note 82, at 151; critical: GUIDO FÖRSTER IN VOLKER BREITHECKER, GUIDO FÖRSTER, URSULA FÖRSTER, RALF KLAPDOR, supra note 67, §15 KStG, at 8.

[137] Norbert Herzig and Bernhard Liekenbrock, supra note 137.

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Concerning the businesses deemed part of a fiscal unit, we again find the *substance over form* approach provided for by Section 4h, subsection 3, 5 dEStG, which states that a business is considered affiliated to a group if it is – or it could be – included among consolidated financial statements. Continuing in this logic, Section 4h III, 6 dEStG states that a business is considered to be part of a group when its financial and managerial choices are taken, or could be taken together with those of another or more other businesses.[138]
In this respect, the notion of control refers to the one of international accounting standards (IFRS 27.13) as control is deemed to be existing also without formal rights to exercise it, simply based on factual forms of influence referred to the managerial decisions of the company itself.[139]

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[138] *Thomas Töben and Hardy Fischer*, supra note 116, at 976.
[139] BT-Drs. 16/4841, p. 86; *Roland Fischer and Thomas Wagner*, supra note 75, at 1876.

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2. The transplant of the "EBITDA-rule" in Italy

Law 244/2007 represents the last Italian attempt to deal with the fiscal aspects of thin capitalization. While the first rule of such a type, introduced in 2004 was a classical thin capitalization ratio with respect to loans granted by qualified shareholders, this latter rule is applicable to all loans, whether granted by related parties or not. It should be mentioned at this stage (although described exactly below) that, while the former thin capitalization rule was part of a broader system of non-deductibility ratios with specific indices for interest linked to the acquisition of participation eligible for the participation exemption regime and a general non-deductibility ratio, applicable in cases of exempt income linked to deductible expenses, the new thin capitalization rule or interest barrier is explicitly applicable for any sort of interest, regardless of the use made of the relevant loan.

a. Basic features of the transplant

<u>Fiscal treatment of Debt</u>

As stated above, the previous non-deductibility rule demanded the calculation of certain ratios which, again, were used to calculate a portion of non-deductible interest. The old rule followed a static logic; it determined the non-deductible portion with help of the proportion between equity and debt, allowing only deductions of interest referring to debt representing four times the relevant equity. This all in terms of loans granted by qualified shareholders, where the qualification applied in certain, well-defined cases. The new rule, contained in Section 96 of Testo Unico delle Imposte sul Reddito,[140] on the other hand, applies by means of an economic indicator, allowing the deduction of interest only up to a certain percentage of the earnings. Summing up, under the new system the difference between interest income and interest expenses for the remuneration of debt and assimilated costs are deductible from the

[140] Testo Unico delle Imposte sul Reddito, Italian Income Tax Act, officially cited as D.p.r. 22 dicembre 1986 n. 917 - Approvazione del testo unico delle imposte sui redditi, pubblicato sul supplemento ordinario alla "Gazzetta Ufficiale" del 31 dicembre 1986 n. 302, from now on TUIR.

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entity's income up to an amount equal to 30 per cent of the earnings before interest, tax, depreciation and amortization. Exceeding interest, not deductible in the fiscal year, may be carried forward unlimitedly, under the condition that it respects the 30 per cent barrier in the relevant, following year. In cases of fiscal units, exceeding interest may be attributed to the fiscal result of the whole group, if the unit presents an overall 30 per cent barrier able to include the exceeding portion.

Rationale of Section 96 TUIR

There has always been a big discussion on the legal and economic rationale and sense of thin capitalization rules,[141] from the beginning of the use of such an instrument in the seventies (discussion on economic justification of the institute), through the measures again international tax avoidance (nineties), the influence of the European Court of Justice to the present discussion. Thin capitalization rules were one of the most important measures to counteract international tax avoidance. In fact, the deduction of interest in one country with high tax rates and the attribution of the interest to a company in a country

[141] Detlef Piltz, *International aspects of thin capitalization – General report*, LXXXIb CAHIERS DE DROIT FISCAL INTERNATIONAL, CARLO GARBARINO (ED.), ASPETTI INTERNAZIONALI DELLA RIFORMA TRIBUTARIA 237 (2003); ALAN AUERBACH, TAXATION AND CORPORATE FINANCIAL POLICY, in ALAN Auerbach and MARTIN FELDSTEIN (eds.), HANDBOOK OF PUBLIC ECONOMICS 1251 (2002); THIESS BUETTNER AND MICHAEL OVERESCH AND SCHREIBER AND GEORG WAMSER (2006), TAXATION AND CAPITAL STRUCTURE CHOICE – EVIDENCE FROM A PANEL OF GERMAN MULTINATIONALS, CESIFO WORKING PAPER NO. 1841; CLEMENS FUEST AND THOMAS HAMMELGARN, CORPORATE TAX POLICY, FOREIGN FIRM OWNERSHIP AND THIN CAPITALIZATION, REGIONAL SCIENCE AND URBAN ECONOMICS 508 (2005); Andreas Haufler and Guttorm Schjelderu, *Corporate Tax Systems and Cross Country Profit Shifting*, 52 OXFORD ECONOMIC PAPERS 306 (2000); Harry Huizinga and Luc Laeven and Gaetan Nicodème, *Capital Structure and International Debt-shifting,* 88 JOURNAL OF FINANCIAL ECONOMICS 80 (2008); Pascal Hinny*, New tendencies in tax treatment of cross-border interest of corporations, General Report,* in 93b CAHIERS DE DROIT FISCAL INTERNATIONAL; Robin Boadway and Neil Bruce, *A General Proposition on the Design of a Neutral Business Tax*, 24 JOURNAL OF PUBLIC ECONOMICS 231 (1984); Michael Devereux and Harald Freeman, *A General Neutral Profits Tax*, Fiscal Studies 12/3 (1991); IFS Capital Taxes Group (1991) *Equity for Companies: A Corporation Tax for the* 1990s, Commentary note 26, The Institute for Fiscal Studies; Ekkehard Wenger *Gleichmäßigkeit der Besteurung von Arbeits- und Vermögenseinkünften*, 41 FINANZARCHIV 207 (1983); CHRISTOPH KASERER, RESTRICTING INTEREST DEDUCTIONS IN CORPORATE TAX SYSTEMS: ITS IMPACT ON INVESTMENT DECISIONS AND CAPITAL MARKETS (2008) 15.

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with low or non-existing imposition on the interest gave the possibility of tax arbitrages, which were put in place by many multi-national enterprises. Many countries reacted by stating the non-deductibility of interest paid to companies resident abroad. This, for cases of communitarian lenders, led to the aforementioned ECJ-ruling and the consequent modification of the rules with applicability also to pure domestic cases. Thin capitalization rules always applied only to loans contracted between a company and its shareholders and in dependence of the level of control present. This leads to a system based on book values of the participation and the book value of the debt. Those values have to be determined in a continuous way, leading to some problems in terms of book-keeping and administrative costs.

The modern form of interest deductibility rules follows a completely different approach. It is based on economic and not book values, the limitation is in proportion with the EBIT, an economic result, determined for each fiscal year. The non-deductibility derives from a barrier of a certain percentage of the EBIT and is referred to all interest payments. This is a clear simplification, as all interest payments result from the books of the company either way. This means that what was an anti-avoidance rule referred to inter-group interest payments, becomes a broad thin capitalization rule referred to the financial position of the company with respect to all lenders, whether shareholders or not. The dynamics are interesting, also for the analysis of the relevant tax model and its evolution: previously applicable thin capitalization rules were included in a model with a broader sphere of application and a rationale partly diverging from the one of the formerly applicable rule. What we have now is a rule limiting the financial exposition of a company, encouraging a higher equity capitalization. This rule was basically introduced to broaden the tax base and consequently be able to reduce the tax rate.[142] It will have to be analysed whether a set of rules of such nature takes its inspiration from other tax

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[142] Salvatore Biasco, *La nuova riforma dell'imposizione sulle imprese a confronto con le conclusioni della Commissione sull'Ires*, 43 IL FISCO 6203 (2007); Saverio Capolupo, *Manovra finanziaria: la nuova disciplina degli interessi passivi*, 39 IL FISCO 5675 (2007); Francesco Crespi and Antonio di Majo and Maria Grazia Pazienza, *La riforma italiana della tassazione delle imprese e i suoi effetti Sulle decisioni di investimento*, Document of the seminar by SIEP, *Economia della tassazione: sistemi tributari, pressione fiscale, crescita*, Pavia, 25th and 26th september 2008.

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systems[143] or if it follows an international trend, being definable as an application of an international corporate tax model.[144]

Operative structure of Section 96 TUIR

The structure of Section 96 TUIR is as follows: a general rule for the calculation of non – deductible interest, which is formed of two basic rules. The first limitation states that interest is deductible for the difference between interest income and interest expenses, calculated every fiscal year (Section 96, subsection 1, sentence 1 TUIR).

The second limitation prescribes that the difference resulting from the first limitation is deductible for an amount equal to 30 per cent of the entity's EBITDA; (Section 96 TUIR, subsection 1, sentence 2).

In the consequence there are rules for the determination of the subjective scope of application, rules for the calculation of the relevant portion of deductible interest, rules for the portion of non–deductible interest that can be carried forward: interest exceeding the limitation of 30 per cent of the entity's EBITDA can be carried forward if subsequent EBITDA's are high enough (Section 96 TUIR, subsection 4), rules for the portion of non-deductible interest expenses which can be off-set against the fiscal income of the fiscal group the relevant entity is part of. This possibility arises if other companies of the fiscal group present EBITDA's which result in an overall group EBITDA strong enough to comprehend the single entity's interest expenses (Section 96, subsection 7 and 8 TUIR);

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[143] Giuseppe Galeano and Alan Rhode, *Italy sets the Barrier to Deduction of Financing Costs at 30 Per Cent of EBITDA*, 36 INTERTAX 292 (2008).
[144] Carlo Garbarino, *Tax Transplants and Circulation of Corporate Tax Models,* BOCCONI LEGAL STUDIES RESEARCH.

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<u>Operative definitions stated as basics for the rule</u>

The relevant legislative provision, Section 96 TUIR includes a series of practical notions necessary for the practical application of the mechanism itself. Those definitions are either included in the provision itself or general definitions stated by the Italian tax legislation. The easiest way to give an overview concerning those basics is to state the time-line for the application of the mechanism: starting with the calculation of the difference between interest income and interest expenses, the calculation of "modified" EBITDA, calculation of the non–deductibility barrier, carry-forward of non–deductible interest expenses, off-setting of non-deductible interest expenses.

b. Objective and subjective requirements

The rule as provided for by Section 96 TUIR is mainly applicable to entities subjected to the Corporate Income Tax Act. This means that, specifically, these entities are corporations, cooperative companies and mutual insurance companies, resident in Italy; Public and private bodies, resident in Italy, commercial and not commercial; Companies and bodies, with and without legal personality, not resident in Italy but present on the territory through a permanent establishment;

According to Section 152, subsection 1, TUIR, which refers to the determination of the taxable income realized by permanent establishments of non-resident companies, and which makes direct reference to the provisions stating the rules of income determination for resident companies, it seems that Section 96 is applicable also to permanent establishments of non-resident companies. Of course, this link is suitable under the condition that all data in this respect is available, such as the basic values to determine the non–deductibility ratio, the definition of the relevant passive interest, the definition of the relevant EBIT and, consequently, the relevant portion of deductible interest and the part that can be carried forward. It must be clear that the portion of deductible interest is determined using the books of the permanent establishment as a basis. Entities not holding a permanent establishment in Italy are not in the sphere of application of the rule.

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Excluded types

While the formerly applicable thin capitalization and pro rata rule were compulsory also to individual persons, this is no longer the case since the introduction of Section 96 in its actual form, Section 62 and 63 TUIR.
There is no specific necessary classification of the interest concerning its origin, the last titleholder of the loan and, consequently, the nature of the perceiving entity. It could be a corporation, a public or private body, an individual person or the parent company in cases of group structure, whether it holds a subsidiary or a permanent establishment.

Banks and financial entities

One of the most sensible categories of companies concerning interest deductibility limitations is the one referring to the financial sector, such as banks and insurance companies. Accordingly, Italian Tax Reform Law No. 33/2008 makes specific reference to that category of company by stating specific rules, contained in subsection 5-*bis* of Section 96 TUIR.
The exact definition of bank is given by Italian Bank Law, Testo Unico Bancario in Section 61, subsection 1, to which reference is made by means of the relevant Resolution No. 91/E/2009 of the Italian tax authority. The same is put in place through special provisions for insurance companies by means of Section 83 of Decree No. 209/2005.

At the beginning of the legislative process concerning the Italian EBITDA rule, it seemed that the rule would have been made non applicable to banks and insurance companies. This because of its complexity for those kinds of companies and also because of the particular business model put in place by such companies. This is also the reason for the fact that they were allowed to entirely deduct their interest expenses.

The new system provides a different rule stating that banks and insurance companies are allowed to deduct their interest expenses up to 96%. This is a sort of minimum taxation for these companies with respect to interest. (see subsection 5-bis of Section 96 TUIR).

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It has been stated by tax Circular 19/E/2009 issued by Italian tax authority that, for reasons of rationality, the provision applies also to charges assimilated to interest expenses given that these charges arise from financial contracts. Note that, because of the fact that banks and insurance companies are obliged to draft their financial statements according to IFRS, the relating issues concerning the criteria of qualification, temporal allocation and classification provided by IFRS are relevant to this purposes.

In fact Section 83 TUIR states that the criteria provided by IFRS concerning qualification, temporal allocation and classification are valid to the purposes of TUIR form those companies drafting their records according to IFRS. This has the ultimate effect that Item 20 – Interest expenses and assimilated charges of the reference scheme of income statement, provided by the memorandum No. 262/2005 issued by Banca d'Italia should be taken as calculation basis.

The afore stated amount equal to 4% which is deemed non-deductible concerning interest expenses put in place by banks and insurance companies is flat. This means that it is referred to the gross amount resulting from the typical interest margin of a bank, earned through the carrying out of their core business. There is no possibility to carry forward the portion of interest deemed non-deductible. This means that the 4% portion of interest expenses is deemed non-deductible in a definitive way.

The only possibility to avoid that flat amount of non-deductible interest is to participate in a fiscal unit. Subsection 5-*bis* granhts the right to deduct the whole amount of interest up to the total amount of accrued interest paid to subjects external to the tax consolidation.

The relevant adjustment will be put in place by the parent company which is allowed to deduct the 4% amount from net total income of the consolidated income statement, provided for tax consolidation purposes.

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Comparison with the formerly applicable sphere of application

The old version of the Italian thin capitalization provision had a quite limited sphere of application: it was not applicable to companies with a turnover lower than 7,5 Million € and the non-deductibility of interest referred to the acquisition of exempt participations, the so called *pro rata patrimoniale* was applicable under the condition of certain participations held by the company, the new provision, the afore state dEBITDA rule is applicable to all sorts of companies.

This leads to two types of consequences: the number of companies included is consistently higher than before, including also small companies formerly excluded and holding companies are included in the scope of the provision as well.

If the majority of a company´s assets are booked in the class of financial assets and if its revenues consist in profits from financial assets, from profits deriving from operations concerning the trade with currencies and of the commission revenues deriving from provided services is higher than 50% of the total revenues, its holding activity represents the main activity according to document No. 19/E/2009 issued by Italian tax authorities.[145]

The following companies are expressively excluded from the application of Section 96, subsection 5, TUIR due to the specific operating and managerial features that do not justify the application of the provided rules:
temporary unions of companies set up for unitary, partial or total, execution of works, pursuant to Section 96 according to Decree No. 554/1999; project companies established in accordance with Section 156 of the Code of Public Contracts relative to Works, Services and Supplies, provided by D. Lgs. No. 163/2006; companies established for the realization and carrying out of freight terminals pursuant to Law No. 240/1990;

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[145] As stated before, banks, insurance companies, parent companies of banking and insurance groups and other financial entities are excluded by the scope of application of Section 96, subsection 1, TUIR: as already mentioned, Law No. 133/2008 provides specific rules concerning this kind of entities, which will be further analysed.

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companies whose share capital is mainly subscribed by public entities that build or manage water facilities, energy and district heating facilities, as well as disposal and depuration facilities.

These companies being excluded from the scope of application of Section 96 TUIR, can fully deduct the relevant interest expenses. The aforementioned rule doesn´t give raise to opportunities of tax planning as Resolution No. 268/E/2008 of the Italian tax authority states that provided list is closed and therefore could not be enlarged by analogy.

There are no particular conditions referred to the person granting the loan: the EBITDA rule is applicable to any kind of loan granted by any kind of lender under certain conditions concerning the borrower. What he have here is one of the most substantial differences to the formerly applicable rule.

Remuneration of debt

The definition of interest, relevant for the application of the EBITDA rule is provided for by Section 96 TUIR. The term reference is made to I "interest and similar expenses". The general definition is consequently limited by certain specific cases.

Financial contracts, such as leasing contracts, loans, placement of bonds and similar debt titles as well as every other contract of financial nature, lead to payments relevant for the application of the provision as passive interest according subsection 3 of Section 96 TUIR excluding implicit commercial debt. This is the same as provided for under the old version of Section 98 TUIR ("Thin Capitalization Rule") which had the additional condition that those payments were relevant only if made or guaranteed by shareholders or related parties.

Loan contracts and leasing contracts are the two types of contracts to be included in the sphere of application of this provision. The second issue concerns the fact that there are some contracts in a residual category: "every other contract of financial nature", which includes all cases of contracts of financial nature. This means that provision identifies some typical standard contracts and a residual category of contracts having financial nature. These

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contracts consist in all those contracts, not typically defined as loans or financings, presenting specific financial characteristics although not being pure loans or leasing contracts.

According to Circular 11/E of 2005, operational deposits, not of a financial nature and zero balance cash pooling contracts[146] have to be excluded from the EBITDA rule, this should still be applicable for the new version of Thin Capitalization provisions.
Nonetheless, the new Section 96 TUIR has a very extensive scope of application as it tries to comprehend all types of financial contracts except those explicitly excluded.

The day by day business will show if the intention of the legislator was a little bit to ambitious as, for the case of inclusion of contracts with financial nature, it seems very difficult to isolate the financial element form mixed contracts and evaluate it.

Interest and similar income

It has been mentioned before that the basis of the provisions on the scope of the Italian EBITDA rule, as provided for by Sec. 96 TUIR consists in including loan and leasing contracts as a bsis and extending the concept to other cases not listet but included by determination.

Section 96, subsection 3, first sentence, TUIR states that , *active interest and assimilated income, deriving from loans, from leasing contracts, from the emission of bonds and similar titles and from any other contract having financial nature, excluding implicit interest deriving from commercial payables.* On the side of the relevant active interest, *all credits of the same nature are included.*

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[146] Notional cash pooling, having a consolidated financial nature, are included in the debt category.

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Consequently, the relevant income is:

- Active interest and similar income;
- As that from loans;
- From leasing contracts, the emission of bonds and similar titles;
- From credits of commercial nature;
- From interactions with public bodies (so called "virtual active interest");

As stated before for the case of passive interest, implicit interest of an active type deriving from commercial businesses is not relevant as well as passive interest of implicit nature. A special rule is provided for the entities operating with the public administration is explicit and stated by subsection 3 of Sec 96, TUIR.

Fiscal EBITDA (i.e. ROL – reddito operativo lordo)

The first step in the application of the Italian EBITDA rule is to verify if the amount of interest expenses is higher than that of interest revenues, as interest payments can be fully deducted up to that figure according to Section 96 TUIR. The latter rule was apparently introduced to reduce the penalizing effect with reference to those companies that, without taking into consideration the active interest income, would have high interest payments such as those companies responsible for the group´s cash pooling.[147]

The relevant limitation for the deduction of interest is equal to 30% of EBITDA. The concept of EBITDA applicable in this respect is defined by Section 96, subsection 2 TUIR as the difference between revenues and production costs, accordingto letters A) and B) of Section 2425 Italian Civil Code after the

[147] Dario Stevanato and Raffaello Lupi, *Prime considerazioni sui limiti generalizzati alla deducibilità degli interessi passivi introdotta dalla manovra finanziaria 2008*, 10 DIALOGHI DI DIRITTO TRIBUTARIO 1219 (2007), Giovanni Palumbo, *Principio d'inerenza e interessi passivi*, 9 RIVISTA DI DIRITTO TRIBUTARIO 805 – 826 (2007), Pierpaolo Lipardi and Stancati Gianluca, *La nuova disciplina di deducibilità degli interessi passivi – Profili applicativi e sindacato di inerenza*, 4 BOLLETTINO TRIBUTARIO 298 (2008), Silvia Giannini and Dario Stevanato Raffaello and Lupi, *Quali giustificazioni per l'indeducibilità degli interessi passivi?,* 1 DIALOGHI TRIBUTARI 13 (2008). ADRIANO MODOLO IN MAURO BEGHIN, SAGGI SULLA RIFORMA DELL'IRES 96 (2008).

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discount of depreciations and amortizations as well as financial leasing rates. Obviously the same is applicable to companies drafting their records according to IFRS with the consequent modifications concerning the single items to be included, which, formally correspondent to what was stated before, could differ from a formal point of view.

The Italian tradition of the so called "double track" which gives high relevance to the outcome of the profit resulting from the profit and loss statement is safeguarded also in this circumstance: it has to be noted that the basic element for the calculation of the non-deductible portion of interest, i.e. the fiscal EBITDA is completely referring to book values and not to values determined by means of tax principles.

c. The interest cap

The first step in the calculation of the relevant portion of deductible interest is to observe the interest balance, i.e. the difference between received and paid interest. According to the first subsection of Section 96 TUIR, interest expenses are deductible up to the amount of interest revenues.

Section 96, subsection 3, TUIR draws the lines of the objective scope of application of the law: all interest expenses, revenues, assimilated charges and revenues linked to loan contracts, financial lease contracts, bonds or similar securities and any other contract having *financial nature*[148] must be considered to the purposes of the EBITDA rule.[149]

Indemnification debts, deposits that do not lead to financings and the zero balance cash pooling contracts were excluded from the scope of application

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[148] Definable as *contracts aimed to procure liquid funds against payment not only with a repayment obligation but also a specific remuneration*, see *ADRIANO MODOLO*, supra note 164, at 93.
[149] Dario Stevanato and Raffaello Lupi, supra note 148; Giovanni Palumbo and Pierpaolo Lipardi and Stancati Gianluca, supra note 148; Silvia Giannini and Dario Stevanato Raffaello and Lupi, supra note 148; *ADRIANO MODOLO*, supra note 164, at 92.

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concerning the previous regulations according to document No. 11/E/2005 issued by Italian tax authorities.
It is common sense[150] that the guideline issued with respect to the formerly applicable regulation is binding also for the new one concerning basic definitions given to figures relevant also for the EBITDA rule.
Notional cash pooling contracts are included in the scope of application of Section 96 TUIR though.

As there is no exist definition of the elements a contract with financial nature must comprehend, the taxpayer should verify if they have financial nature or not and consequently if the relative interest payments have to be considered with respect to the calculation of the relevant interest amounts.

It is a right of the taxpayer to demonstrate the opposite though: this means that he can officially give evidence that a contract considered to be financial by the tax inspector is not of this nature.

Positive interest is the one deriving from the categories expressly included by use of Section 96, subsection 3 TUIR and those relative to employments of resources having financial nature, interest implicit in commercial credits and virtual interest deriving from delayed repayment of considerations put in place by the public administration.

Charges and Revenues deemed interest payments

The wording of Section 96 TUIR also includes assimilated charges and revenues as said before: this enlargement of the relevant scope of application concerns a substantial view and not a merely formal one as provided for by document No. 19/E/2009 issued by Italian tax authority.[151]

[150] Dario Stevanato and Raffaello Lupi, supra note 148; Giovanni Palumbo and Pierpaolo Lipardi and Stancati Gianluca, supra note 148; Silvia Giannini and Dario Stevanato Raffaello and Lupi, supra note 148; *ADRIANO MODOLO*, supra note 164, at 93.
[151] The cited guideline No. 19/E/2009 by the Italian tax authority states that the rule applies for every interest payment, or similar charge linked to the lending of a sum, shares or other replaceable goods – with reference to which a restitution obligation exists and with regard to which a specific compensation is provided.

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Every payment connected with a contractual or factual relationship with an economic content can be deemed as an interest payment or interest income.
The examples listed by guideline No. 19/E/2009 of the Italian tax authority concern passive discounts on loans granted by banks or by other financial institutions, commissions for loans and for securities granted by thirds, other fees related to debt securities, derivatives covering the risk of interest variation, differences between market price and forward price with reference to swaps.

Section 96, subsection 3, TUIR states that delayed payment conditions referred to accounts receivable lead to so implicit interest which has to be included in the interest revenues. On the contrary, implicit interests referred to trade payables must be excluded from interest expenses.

Deemed Interest Relative to Receivables from Public Administrations

Companies holding contracts with public administrations are entitled to use a special a special bonus resulting in the elevation of the relevant interest income. This is because of the very long duration referred to payments by Italian public bodies. The bonus is used by increasing the relevant amount of interest revenue by a sum corresponding to the interest calculated with reference to the receivables from public bodies, determined at the official level, raised by 1% and accounted from the due date of the payment, according to document No. 19/E/2009 by the Italian Tax Administration.
Coherently to what is applicable for accounting in accordance to IFRS, the portion of implicit interest referred to leasing contracts must be included in the calculation of the interest amount relevant for the application of the EBITDA rule according to Section 96 TUIR. Document No. 19/E/2009 issued by Italian Tax Administration provides some simplification for companies not adopting IFRS.[152]

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[152] It is made reference to Art. 1 of Ministerial Decree of 24th April 1998.

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d. The Italian variants of the safeguard clauses

Section 96 TUIR states that amounts of interest deemd non-deductible can be carried forward without limitations.
This regulation is incentivating the company as it is positively encouraged to improve its EBITDA in order to recapture the interest carried forward. Such an incentivizing form of interest carry forward regulations is apparently made necessary because of the very wide scope of the Italian EBITDA rule and its characterisation as instrument of economic policy and not only of tax base consolidation. [153]

As this unlimited carry forward of non-deductible interest for accounting purposes would lead to prepaid taxes, some problems can arise: the impact on financial records is very high[154] especially for industrial holdings because of their financial structure and there are strong doubts at which amount those tax reserves should be booked as Section 2423-bis Italian Civil Code demands the use of the prudence principle in this respect. This principle is detailed by Italian GAAP No. 25 asking for reasonable certainty with objective elements that support it.

Also portions of the relevant EBITDA can be carrie forward if not used in one certain fiscal year. This carry forward mechanism does not have a time limit. If a portion of EBITDA is not fully consumedin a certain fiscal year, that portion can be added to the 30% of the EBITDA of the following fiscal years.

Section 96, subsection, subsection 7, TUIR states that in the case of a domestic tax consolidation, participating companies are allowed to transfer their surplus of non-deductible interest expenses and assimilated charges to the fiscal unit in order to reduce the group´s total income. This possibility is not applicable to banks, insurance companies and to the other financial entities (see Section 1,

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[153] Dario Stevanato and Raffaello Lupi, supra note 148; Giovanni Palumbo and Pierpaolo Lipardi and Stancati Gianluca, supra note 148; Silvia Giannini and Dario Stevanato Raffaello and Lupi, supra note 148; *ADRIANO MODOLO*, supra note 164, at 102.
[154] Pierpaolo Lipardi and Gianluca Stancati, *La nuova disciplina di deducibilità degli interessi passivi – Profili applicativi e sindacato di inerenza*, 4 BOLLETTINO TRIBUTARIO 298 (2008).

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Decree No. 87/1992). This is obviously possible only if there are portions of the relevant EBITDA not used yet and consequently able to comprehend the higher amount of interest: this means that the transferred interest becomes part of the ordinary gross interest amount.

The same treatment is granted to EBITDA surpluses which can be used at the level of the holding company but not for that amounts that have been booked befor the entrance into the fiscal unit according to document No. 19/E/2009 issued by Italian tax authority. Additionally, the cited document also highlights that portions of EBITDA not used cannot be transferred to the fiscal unit if referred to companies that are included in the tax consolidation but excluded from the scope of application of Section 96 TUIR.

Companies with EBITDA surpluses cannot transfer it to the fiscal unit and have it carried forward as the surplus can be carried forward only by the company that has generated it in the specific case that no other company that is part of the tax consolidation has a surplus of non-deductible interest.

The decision whether to carry forward the individual EBITDA or interest surplus make it impossible to transfer the relevant surplus to the fiscal unit in the following years.

3. The Austrian approach: flexible criteria

The Austrian tax system does not provide specific rules counteracting the issue of thin capitalization on the legislative level, however there is a combined set of legal rules, administrative principles and jurisprudence leading to a certain tax model designed to fight excessive debt.[155]

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[155] GERNOT RESSLER, DIE UNTERKAPITALISIERUNG IM KÖRPERSCHAFTSSTEUERRECHT, in GEROLD STOLL, WOLFGANG GASSNER, MICHAEL LANG, JOSEPH SCHUCH, KLAUS STARINGER (EDS.), SCHRIFTEN UND AKTUELLE BEITRÄGE ZUM ÖSTERREICHISCHEN ABGABENRECHT (2008).

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The Austrian attempts to limit excessive debt concern only shareholder financing as expenses incurred in acquiring, securing and maintaining taxable income are generally deductible from the company´s tax base. This means that, differently from what is happening in other tax systems, interest on loans and other debts to third parties economically connected with any type of income is generally deductible.

As stated afore, remunerations of shareholder loans or loans contracted with parties related to shareholders are subject to arm's length standards.

The final consequence is that when interest is charged at excessively high rates it may be deemed as a "hidden profit distribution." Such interest is then not deductible.[156]

The VwGH,[157] in its relevant rulings[158] stated that there should be rather flexible case by case limitations concerning the deductibility of interest referred to shareholder loans. There is a certain experience concerning the acceptable debt:equity ratio which had been deemed acceptable with reference to values between 1:7 and 1:2 but this doesn´t appear to give enough certainty to be considered as a general rule,[159] this because reference was made to the average values for the ratio in the relevant industry of the considered entity.

What is clear for the purpose of this analysis is that, firstly, the model used by the Austrian tax administration and tax courts is referable to one of equity based ratios and, secondly, that the acceptable ratio has not yet been stated in a general way but bears the risk of being continually modified by means of new jurisdictional cases setting forth innovative standards or industry definitions

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[156] REINHOLD BEISER, STEUERN- EIN SYSTEMATISCHER GRUNDRISS (2009); CHRISTIAN PRODINGER, *Einführung in das Steuerrecht* (2009).
[157] Verwaltungsgerichtshof, the highest administrave court, in jurisdictional charge for tax matters.
[158] Decision of 23 October 1984, note 83/14/0257; VwGH, 28 April 1999, 97/13/0068, ÖStZB 1999/610 and VwGH, 14 December 2000, 95/15/0127, ÖStZB 2001/393 show a rather reluctant attitude towards the statement of uniform indicators of non acceptable debt:equity ratios.
[159] VwGH, 28 April 1999, 97/13/0068, ÖStZB 1999/610 and VwGH, 14 December 2000, 95/15/0127, ÖStZB 2001/393; Einkommensteuerrichtlinien 2000, Zl. 06 0104/9-IV/6/00 (EStRl), Körperschaftsteuerrichtlinien 2001, Zl. 06 5004/11-IV/6/01 (KStRl).

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and, thirdly, that the limitations concerning interest deductions are applicable only with regard to shareholder loans and not, as analysed for the German and Italian cases, for all kinds of interest-bearing loans contracted by the entity.

An additional case concerns the situation of acceptable debt:equity ratios but contractual conditions referred to shareholder loans that will not be accepted as being contracted at arm´s length. This can be the case because of the substance or the form of the relevant shareholder loan agreement.[160]

A particular case described in the chapter about Austrian participation exemption concerns the link between exempt income and deductibility of connected costs as set forth by Section 10 öKStG which stated that financing costs referred to partially exempt financial income was not deductible. The letter rule had consequently been abandoned by means of the 2005 tax reform.[161]
The tax reform of 2010[162] introduced a new set of rules which state that financing costs for the purchase of participations from independent parties is deductible, financing costs for the purchase of participations formerly held by companies of the same economic group is no longer deductible, all confirming the general rule that costs directly connected with exempt income are not deductible.[163]

Flexible administrative criteria to identify the critical debt

Section 22. subsection. 1 Bundesabgabenordnung[164] states that *the obligation to correspond taxes cannot be reduced or avoided by means of abusive designs made under civil law.* This is logically the first entrance door for tax wise

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[160] Paul Doralt and Wolfgang Feyl, *Austria*, EUROPEAN TAXATION 370 (2005).
[161] Eva Eberhartinger and Peter Quantschnigg Roland, *Determination of Company Profits in Austria*, 58 BULLETIN FOR INTERNATIONAL TAXATION 8 (2004).
[162] Budget Accompanying Act 2011 (Budgetbegleitgesetz 2011), which was promulgated on 30 December 2010 in the Federal Law Gazette.
[163] Andreas Baumann and Martina Gatterer, *Austria - Far-Reaching Changes in Austria Stemming from the Budget Accompanying Act 2011*, 51 European Taxation 5 (2011).
[164] Bundesabgabenordnung, General Tax Code of Austria in its form stated in BGBl. Nr. 194/1961 last changed by law in BGBl. I Nr. 112/2011, form now on BAO.

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corrections of obligations contracted under civil law, e.g. shareholder loans deemed hidden capital contributions and consequent hidden profit distributions.

Section 8 öKStG states that it is not relevant if profit is distributed by means of open or hidden distributions, retrieved or used.

The next step occurs typically in tax inspections and assessments and consequent ruling provided by the courts. As mentioned afore, the Austrian tax courts stated that compensations of shareholder loans referred to companies with debt to equity ratios far below the industry's standard had to be considered remunerations attributable to hidden equity compensations and therefore had to treated as deemed dividends with consequent non-deductibility from the tax base.

This means that a figure of equity considered not adequate, leads to the consideration that a quota of the debt referred to shareholder loans may be regarded as the equivalent of shareholders' equity.

Moreover, the remuneration of the loans that are regarded as "disguised capital" will be treated as hidden profit distribution with the consequence that such interest may not be deducted from the taxable income.[165]

The next possibility in dealing with excessive debt given to the Austrian tax administration is represented by cases of shareholder loans respecting the relevant debt:equity ratio but not being contracted at arm´s length. Austrian tax authorities may, in this case, qualify loans granted (or guaranteed) by shareholders or other related parties as hidden equity. This makes reference to a series of typical contractual conditions and the contractual form itself which would not have been agreed between independent parties.[166]

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[165] WIESNER, SWK, 1984, AI, 186; Paukowitsch, Achatz, Kapitalgesellschaft 41.
[166] *WERNER DORALT AND WOLFGANG FEYL*, supra note 185.

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Debt from a tax perspective

Given the absolute absence of links between debt financing and shareholders, debt leads to costs generally deductible under the Austrian tax law. Nonetheless, a portion of debt deemed hidden equity[167] will be considered non-deductible. This applies for instance if the financed party's debt-equity ratio is significantly less than the industry average.
There is no clear statement regarding acceptable debt-equity ratios or other safe haven rules in statutory law, the regulations of the Ministry of Finance or in the case law of the Austrian Supreme Administrative Court (Verwaltungsgerichtshof, VwGH), which is the competent supreme court in tax matters.
What can be said is that the relevant debt:equity ratio must be between 1:2 and 1:7.[168]

Further considerations given by the courts consider the formal and substantial qualities of shareholder loans. There is a long list of conditions to be met formally and substantially which leads to the statement of non-deductibility for interest referred to loans which are not contracted for business reasons concerning the financed entity,[169]
explicitly contracted for purposes outside the course of business,[170] the link with repayment of equity.
Another way of analysing interest payments potentially tangible under the stated rules, given an acceptable debt:equity ratio, consists in a precise

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[167] WERNER DORALT AND HANS GEORG RUPPE, STEUERRECHT I.
[168] VwGH, 28 April 1999, 97/13/0068, ÖStZB 1999/610 and VwGH, 14; Decision of 23 October 1984, note 83/14/0257; VwGH, 28 April 1999, 97/13/0068, ÖStZB 1999/610 and VwGH, 14 December 2000, 95/15/0127, ÖStZB 2001/393; VwGH 8.2.2007; 2004/15/0149; VwGH 1.3.2007, 2004/15/0196; VwGH 19.4.2007, 2005/15/002; Decisions of the Austrian Supreme Administrative Court (VwGH), 30 September 1999, 99/15/0106, 0107; and 23 April 2001, 2001/14/0044.
Decisions of the Austrian Supreme Administrative Court (VwGH), 30 September 1999, 99/15/0106, 0107; and 23 April 2001, 2001/14/0044; Decisions of the Austrian Supreme Administrative Court (VwGH), 11 August 1993, 91/13/0005; and 22 December 1993, 91/13/0011; Decision of the Austrian Supreme Administrative Court (VwGH) 17 October 2007, 2006/13/0069.
[169] VwGH 10.2.1987, 86/14/0028.
[170] VwGH 16.11.1993, 89/14/058.

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observation of the capital basis of the company. If the concerned equity basis is under the industry´s standard level, a requalification of interest payments is still possible.

The formal conditions of the relevant loan agreement must meet a certain standard. This means that they must be in the written form and similar as to other usually applicable conditions. The decision on the side of the borrower must be respecting company law and should not be deemed as penalizing.[171]

Closing the circle with reference to loans deemed hidden capital contributions and the consequent qualification as hidden profit distributions of the relevant interest payments, these three additional items concerning the nature of hidden profit distributions must be met:[172] firstly, a closed relationship between payer and receiving subject, for example ownership, secondly, a receiving party or related party which by fact is enriched and, thirdly, a decision on the corporate level taken by will.[173]

Rationale

The basic critical element concerning shareholder financing in Austria is represented by the equity basis of the concerned entity. The Supreme

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[171] STEFAN WILK IN FRANK HERRMANN AND CARL-HEINZ HEUER AND ARNDT RAUPACH (EDS.), KOMMENTAR ZUM ESTG UND KSTG, §8, TZ 100 (2011); GERNOT RESSLER IN MICHAEL LANG, JOSEPH SCHUCH, KLAUS STARINGER, KOMMENTAR ZUM KSTG, §8, TZ 968; BERNHARD RENNER IN PETER QUANTSCHNIGG AND BERNHARD RENNER AND GOTTFRIED SCHELLMANN AND REINHARD (EDS), KOMMENTAR ZUM KSTG, §8.

[172] Körperschaftssteuerrichtlinien (General administrative principles for corporate taxation, Section 14.1.3., EGON BAUER AND PETER QUANTSCHNIGG, KOMMENTAR ZUM KSTG (1988); Reinhold Beiser, *Verdeckte Gewinnausschüttung im Interesse des bonum commune?* 20 ÖSTERREICHISCHE STEUERZEITUNG 493 (2001); WERNER DORALT AND HANS GEORG RUPPE, STEUERRECHT (2000); WERNER DORALT AND HANS GEORG RUPPE, GRUNDRISS DES ÖSTERREICHISCHEN STEUERRECHTS (1996).

[173] KStR, marginal note 751, VwGH 8.2.2007; 2004/15/0149; VwGh 1.3.2007, 2004/15/0196; VwGh 19.4.2007, 2005/15/0020; Lang, Schuch, Staringer, Steuerrecht 1 und 2, WUV Universitätsverlag, (2006); GERNOT RESSLER, DIE UNTERKAPITALISIERUNG IM KÖRPERSCHAFTSTEUERRECHT 28 (2008); Norbert Gahleitner and Johannes Edthaler, Der Konzern 586 (2007); Norbert Herzig and Alexander Bohn, *Internationale Vorschriften zur Zinsabzugsbeschränkung - Systematisierung denkbarer Alternativmodelle zur Zinsschranke*, INTERNATIONALES STEUERRECHT 253 (2009).

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Administrative Court’s reluctance to draw a clear line between acceptable and excessive debt:equity ratios is to be considered a serious problem concerning the certainty of possible tax planning schemes.[174] As a matter of fact both decisions concerned the requalification of shareholder loans into hidden equity contributions with the consequence of remunerations for the loans deemed as hidden profit distributions and the consequent non deductibility of the relevant portion of loan considered equity. The argument used by judges in both cases concerned the industry´s average debt:equity ratio, which is clearly a rather indefinite and unsecure parameter.

Fixed ratios as provided for by the formerly applicable thin capitalization rules in Italy and Germany give certainly a more stable set for the decisions concerning the financing of a company. On the other hand, a variable standard is certainly more coherent with economic reality and its development in time.

Certainly, the preferable way of determination of the accepted debt:equity ratio is to be seen in a system of constantly adjusted, publicly available debt:equity ratio, as provided by the Swiss tax administration by means of their administrative guidelines stating the presently acceptable portion of debt referred to single asset positions.[175]

a. The scope of the limitation rules

Remuneration of debt

The first step in determining whether a shareholder loan has to be considered a as hidden capital contribution, consists in the application of the average debt:equity ratio of the relevant industry. Additionally, there is a series of conditions to be respected for shareholder loans in consideration of the specific loan agreement itself. The criteria usually applied concern the cash flow analysis put in place at the moment of subscription of the loan itself. It has

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[174] VwGH, 28 April 1999, 97/13/0068, ÖStZB 1999/610 and VwGH, 14 December 2000, 95/15/0127, ÖStZB 2001/393.
[175] Circular 6 of 6 June 1997 by the Federal Tax Administration.

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been stated that the borrower must be in the objective condition of being able to repay the loan under its regular future cash flow.
If a borrower has a future cash flow plan insufficient to serve the interest and the repayment of principal under arm's length loan terms, this will probably lead to a requalification of the loan as equity.

An additional condition concerns the borrower´s ability to obtain loans from third parties. If history shows that the financed entity did not succeed in third party financing by independent financial institutions, or if financing had been offered only under disadvantageous conditions, it is probable that the subscription of a shareholder loan at the same moment will be considered a deemed capital contribution.

If a loan carries along rights similar to typical shareholder rights,[176] i.e. voting rights, rights to receive profits and liquidation amounts, it could easily happen that it is defined as hidden equity according to the definition in Sec 14 of the öKStG. This quite narrow definition typically gave rise to a series of tax planning schemes using hybrid equity instruments, considered interest bearing and therefore reducing taxable profits and contemporarily being definable as mezzanine equity. The typical example is that of silent partnerships in corporations. It has often happened that very extreme schemes of hybrid structure for debt/equity instruments have been re-qualified into hidden equity contributions and their remuneration consequently taxed.

Cases of informal loan contracts as, for example, loan contracts concluded orally, lead to a requalification almost every time. This issue often causes problems due to Austrian stamp duty planning. Under the Austrian Stamp Duty Act (Gebührengesetz, GebG), written loan agreements and signed by both parties are subject to 0.8% stamp duty on the basis of the loan principal. It has happened that tax payers had to deal with the suspect of having contributed hidden capital because of the circumstance that the relevant loan agreement had not been concluded in a written way in order to save the stamp duty. This,

[176] Sec 14 öKStG.

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according to Administrative Supreme Court, is clear proof of loan agreements not agreed at arm's length.
In this respect, it has been highlighted that it is extremely important to dispose of written documentation although it may still be possible to have an agreement in writing, but no document subject to stamp duty (for example, in respect of an agreement signed and deposited abroad or an offer deed with factual acceptance);
Another case of hazardous shareholder loans is that referred to cases of missing arm's length collateralization, connected to high interest rates or absence of conditions for the repayment of principal terms. This rather obvious argument has repeatedly been used by the Administrative Supreme Court to justify the requalification of debt as hidden equity;

As mentioned previously and considered important also in this respect, a particular case described in the chapter about Austrian participation exemption concerns the link between exempt income and deductibility of connected costs as set forth by Section 10 öKStG which stated that financing costs referred to partially exempt financial income was not deductible. The letter rule had consequently be abandoned by means of the 2005 tax reform.[177]

In addition, if a shareholder loan is re-qualified as hidden profit contribution, it has to be treated as equity for capital duty purposes under the Austrian Capital Transfer Tax Act (Kapitalverkehrsteuergesetz, KVStG).
Under Section 2, No. 4 of the KVStG, a hidden equity contribution is subject to 1% capital duty.

Non-deductibility portion, i.e. hidden profit distribution

Loans potentially tangible under the Austrian approach to thin capitalization have to be deemed „non proportionate under normal conditions".[178] This is done by the specific use of the link between the general criterion as stated for

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[177] Eva Eberhartinger and Peter Quantschnigg and Roland Rief, *Determination of Company Profits in Austria*, 58 BULLETIN FOR INTERNATIONAL TAXATION 8 (2004).
[178] KSTG 12 (1) iVm 20 Abs 1 und 8 Abs 2.

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by the income tax act and the link provided for by the corporate income tax act.[179]

One major aspect arising during the decision of the tax administration whether a loan has to be deemed as hidden capital or whether, under arm´s length standards, a considered interest is to be considered not acceptable, is the portion of the relevant debt deemed as non-deductible. A long discussion in the academic field and the relevant jurisprudence have led to the generally accepted rule that, if a loan is completely re-qualified into hidden equity, the relevant remuneration is to be considered non-deductible while, if a portion of interest is considered as paid at too high rates, the portion no longer deductible is to be referred only to the difference between the analysed interest and the relevant interest amount calculated at arm´s length. [180]

The latter case leads to constructive dividends or hidden profit distributions which on the side of the party deemed as distributor are treated as ordinary dividends and on the side of the shareholder as dividend income.[181] Once again has it to be stated that only that part of the benefit passed to the shareholder that is deemed to be excessive has to be considered as hidden distribution.

Classical transactions that may be considered hidden profit distributions are: loans made to shareholders either free of interest or at an unreasonable low rate of interest; loans which are given with the intention of not being repaid, loans from shareholders at an unreasonable high rate of interest, leases to or from shareholders on unusual or unreasonable terms.

For the purposes of the assessment referred to the analysed company, hidden profit distributions are treated as follows: no deduction from taxable income as

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[179] *GERNOT RESSLER in MICHAEL LANG AND JOSEPH SCHUCH AND KLAUS STARINGER*, supra note 184.

[180] Werner Wiesner, *Verdeckte Gewinnausschüttungen im Steuerrecht: keine gesetzliche Aussagen zum Begriff, zur Reichweite & zur Wertermittlung*, SWK, 186 (1984); PETER QUANTSCHNIGG AND BERNHARD RENNER AND GOTTFRIED SCHELLMANN AND REINHARD (EDS), KOMMENTAR ZUM KSTG, §8.

[181] ROMAN LEITNER (ed), HANDBUCH VERDECKTE GEWINNAUSSCHÜTTUNG FINANZSTRAFRECHT (2009); LEITNER, ABC DER STEUERN IM PRIVAT- UND UNTERNEHMENSBEREICH (2009).

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a business expense, with the result that corporate income tax is imposed at the normal rate, given the fact that intra-group hidden profit distributions qualify for the participation exemption.

In this respect dividend withholding tax is normally imposed, with the same exemptions and reductions that apply to open distributions[182] and, if distributed to individual shareholders, hidden profit distributions are regarded as business income or investment income with the afore-mentioned rule of a withholding tax designed as final tax at the level of the individual shareholder.

b. The re-characterization of interest as dividends

For the case of intercompany loans, a loan potentially re-qualified as hidden equity contribution leads to the following treatment of the relevant contributions consequently deemed as hidden profit distributions: the relevant interest will be considered non-deductible with the consequence that the company´s profit is adjusted for the relevant amount. Usually late interest payment is charged by the tax administration.

As the interest payment is considered a distribution of dividends some problems arise with respect to the payment of applicable withholding taxes. Normally, distributions are subject to a 25% withholding tax and, again, late payment interest may be charged.[183]

It has to be remembered that, if the holding company is resident in Austria and detaining at least 25 per cent of the distributing entity, no withholding tax is applicable as there is an exemption for this case provided for by the Austrian Income Tax Act.

[182] see infra, in chapter III, Austria.
[183] Sec. 205 BAO and KStRl, marginal reference 1004.

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A similar treatment is applicable for qualified shareholders under the EC Parent-Subsidiary Directive which, under specific conditions, apply for the full refund of the withheld taxes.

Obviously, it is not possible to claim for a liberation of the withholding tax for EU participations as applicable for open profit distributions between Austrian companies and their EU resident parents,[184] as it is difficult to imagine that the Austrian taxpayer applies declares future hidden profit distributions. There is, so to speak, always the disadvantage given by the deferral between hidden distribution, requalification as dividends, payment of the withholding tax and consequent refund.

Deductibility of costs connected to exempt income

The Austrian tax system doesn´t provide for specific tax models dealing with the problem of leveraged buy outs. Italy and Germany, before the introduction of the Ebitda rule, had specific non deductibility rules that resulted in a portion of non-deductible interest if referred to the acquisition of participations falling under the participation exemption.

Several decisions by the Austrian Federal Tax court and other independent bodies on the ministerial level[185] held interest expenses economically connected with the acquisition of potentially exempt participations as deductible . In addition, the Ministerial Guidelines to the Austrian Corporate Income Tax Act[186] were changed accordingly.

The Courts made it very clear that there is a sharp difference between the tax treatment of interest incurred in financing dividend distributions and interest incurred in financing the repayment of equity.

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[184] Sec. 1 Z 2 of the ordinance on the application of the EC Parent-Subsidiary Directive (Verordnung zu (Ordinance on) Sec. 94 (2) of the EStG, BGBl 1995/56).
[185] Decision of the Independent Fiscal Senate (UFS), 12 April 2007, RV/1102-L/02, RV/0262-L/05.
[186] Körperschaftssteuerrichtlinien (KStR) 2001, note 17.3.3.6, 2008 version.

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Section 8(2), öKStG states that any use of profit and, consequently, any distribution of profit – no matter if open or hidden – is irrelevant for the purpose of the calculation of the company's profit and does not represent a deductible expense.

The link with the business activities is the condition for the deductibility of costs, according to Section 11 KStG which also sets out that accessory expenses immediately connected with equity contributions are deductible (e.g. the capital transfer tax).

In order to analyse the categories of costs incurred with reference to exempt participation, a distinction must be made between costs incurred to fulfil the purposes laid down in the Articles of Association according to Section 12 öKStG, which are not deductible, and those referred to the business activities which, in principle, are deductible as long as they do not relate to taxable income of the company.

If a taxpayer contracts a loan in order to finance the dividend distribution it is questionable if a business expense for the interest payable on the loan could be claimed.[187]

The case law cited above shows the tendency to disallow the deduction of those expenses as it is doubtful if they relate to the business activities of the taxpayer. The loan was consequently deemed as expense related to the "use of the profit" in the sense of Section 8 öKStG with the consequence that the connected interest was deemed not deductible.

Section 11 öKStg permits the deduction of every cost connected to the provision of capital but interest costs are not listed in the index provided for by

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[187] Decisions of the Austrian Supreme Administrative Court (VwGH), 30 September 1999, 99/15/0106, 0107; and 23 April 2001, 2001/14/0044.
Decisions of the Austrian Supreme Administrative Court (VwGH), 30 September 1999, 99/15/0106, 0107; and 23 April 2001, 2001/14/0044.

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Section 11 öKStG itself and could therefore be considered costs not related to the company´s business and therefore not accepted as deductible.[188]

The decision in this respect was finally taken by the Austrian Supreme Administrative Court which, accepting the first of the two options shown in the last paragraph, stated that a deduction shall be accepted including the relevant financing cost among business expenses.

Section 11 öKStG states that every cost connected to the business activity of the company is deductible. The question in the aforementioned case is if the relevant loan was contracted in order to finance the company´s business activity or, alternatively, was contracted to repay portions of equity. As for the purposes of company law, a shareholder has the right to perceive profit distributions from the controlled company: it seems that there is a legal title for the distribution of profits or, better, a legal statement prescribing that a company has the potential obligation to distribute profits to the shareholder. The court argued that, being the profit distribution the remuneration for the provision of capital by shareholders and, as such, relating to the business activities of the company, the relevant interest had to be considered deductible.[189]

The profit distribution itself is not deductible of course as it relates to the distribution in a narrow sense and not to financing costs relating to the distribution.[190] Consequently, the Austrian Supreme Administrative Court held expenses incurred in financing a dividend distribution linked to the business of the company and therefore deductible.

The result of this decision was that the Independent Fiscal Senate,[191] and the Ministry of Finance,[192] introduced these stated new principles in their

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[188] Reinhold Beiser, *Fremdfinanzierung von Gewinnausschüttungen*, 171 ÖSTERREICHISCHE STEUERZEITUNG 98 (2002).
[189] Andreas Damböck, *Anmerkungen zur jüngsten BMF Erledigung*, ECOLEX 446 (2000).
[190] Decisions of the Austrian Supreme Administrative Court (VwGH), 11 August 1993, 91/13/0005; and 22 December 1993, 91/13/0011.
[191] Decision of the Independent Fiscal Senate (UFS), 12 April 2007, RV/1102-L/02, RV/0262-L/05.

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guidelines. With regard to hidden profit distributions, the Austrian Supreme Administrative Court stated that the above principles are only applicable to open dividend distributions.[193]

It has to be said at this stage that it can´t be understood why interest for dividend payments is deductible but interest for loans contracted in order to repay capital is not.[194]

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[192] Körperschaftssteuerrichtlinien 2001, note 17.3.3.6, 2008 version.
[193] Decision of the Austrian Supreme Administrative Court (VwGH), 17 October 2007, 2006/13/0069.
[194] *Austria*, 15 INTERNATIONAL TRANSFER PRICING JOURNAL (2008).

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4. The Swiss approach: a variant of the operative rules based on flexible criteria

As stated in the chapter about distribution, Switzerland adopts a classical system for the taxation of corporate profits. Concerning the taxation on the level of the shareholder we find a participation exemption in respect of dividends and capital gains with reference to substantial participations.

The corporate income tax applies for resident companies concerning their worldwide income with the exception of income from a business, a permanent establishment or immovable property located abroad.

Non-resident companies are usually taxable only with regard to certain types of Swiss-source income.
Dividends distributed by Swiss resident companies and interest from bonds issued by Swiss debtors and on bank deposits bear a 35% federal withholding tax. In this respect, it has to be stated that regarding dividends paid to resident companies the payer may apply for an exemption from the obligation to withhold the tax. If the exemption is granted, the payer is allowed to distribute the gross dividend, but must complete a reporting procedure. Other shareholders have to apply for a refund.

As stated above the Swiss constitution grants taxation rights to the single cantons. Only the federal direct tax is levied only on the central level.

The following analysis is again concentrated on the level of the federal direct tax as it is applicable to all cantons by constitutions and as the single cantonal tax systems follow the rules the federal direct is based on by means of the Tax Harmonization Law (THL) which was introduced in 1990 by the Federal Parliament. The law entered into force on 1st January 1993 with the obligation for cantons and municipalities to bring their legislation into line with the law by 1st January 2001. The THL is designed as a set of general guidelines containing

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provisions on tax liability, taxable income, deductions, taxable periods and assessment procedures. The cantons remain free to set their tax rates.[195]

With reference to corporate taxation and the issues relevant for this analysis, it has to be noted that on 24 February 2008, the corporate tax reform II was approved in referendum.
The general intention of the CTR II was to improve the tax treatment for small and medium-sized companies and their owners in Switzerland.

The main issues of corporate tax reform II are the reduction of economic double taxation on dividends paid out to individual shareholders and the enlargement of the sphere of application provided for under the Swiss system of participation exemption.

The results of the reform were a partial exemption for dividends paid to qualified individual shareholders by means of taxation of only 60% of the dividends on qualifying participations (10% shareholding). Those dividends received by individuals holding them as a private asset are taxed at ordinary rates.
If the individual shareholder holds the participation as a business asset, the percentage of dividends or capital gains taxed is 50%.
Concerning dividends distributed to corporate shareholders, Switzerland now adopts reduced conditions in order to determine if the qualifications are to be considered qualifying or not. The threshold for participations is reduced to 10% equity participation or a market value of CHF 1 million (formerly applicable thresholds were 20% or a market value of CHF 2 million);

[195] VAN KOMMER S., Switzerland - Cantonal and Municipal Taxation - Corporate Taxation, Country Surveys IBFD.

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Tax mechanism

From the point of view of the system, the starting point is Section 58, subsection. 1, letter b) Direct Federal Tax Code, where we find the statement that, given the fact that the starting point of the tax calculation is the profit for commercial law purposes, hidden profit distributions are taxable.
The second relevant provision is Section 65 Direct Federal Tax Code, where it is stated that remuneration for hidden equity is not deductible.

While the first provision concerns payments which are not grounded on the arm´s length principle, the sectond provision concerns the relationship between shareholders and controlled company and connected equity portions, portions of shareholder loans and portions of equity deemed as hidden loans.[196]
This leads to the following approach:

1st Step: analysis of the relevant loan concerning interest rate and accessory conditions[197] to determine whether its remuneration has to be considered as hidden profit distribution according to Section 58 DFA;

2nd Step: analysis of the relevant portion of allowed debt concerning certain, specified assets to verify whether there is hidden equity and therefore non-deductible interest according to Section 65 DFT;

This means that Section 65 is accessory as it concerns remunerations of loans which, according to Section 58 have arm´s length interest rates but are not acceptable concerning the overall capitalization of the company itself. Section 65 is therefore the true Thin Capitalization provision as it limits interest payments to shareholders, whether the rate respects arm´s length criteria or not.[198]

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[196] PETER BRÜHLISAUER AND JEAN ZIEGLER AND MARTIN ZWEIFEL AND PETER ATHANAS (eds), KOMMENTAR ZUM SCHWEIZERISCHEN STEUERRECHT, DIREKTE BUNDESSTEUER, 1062 (2011), marginal reference 3.
[197] ERNST KÄNZIG, KOMMENTAR ZUM SCHWEIZERISCHEN STEUERRECHT II, Art. 49 marginal reference 85; LOUIS BOCHUD, EINFÜHRUNG IN DAS STEUERRECHT. DIREKTE STEUERN 307.
[198] HÖHN, WALDBURGER, 492, AGNER, JUNG, STEINMANN, Art. 65 N.2.

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This means that interest is generally deductible in the Swiss tax system. If connected with the business activity, it is accepted for purposes of the Direct Federal Tax, Section 58, subsection. 1, if representing a hidden profit distribution or compensation for hidden equity, Section 4, subsection. 1 letter b) VSTG, it is not deductible.
It is stated quite clearly that all interest for loans not contracted from shareholders is fully deductible and also interest for loans contracted in order to buy participations.[199]

The relevant conditions for the determination of the portion of interest not deductible under the Swiss rules have been determined by Circular 6 of 6 June 1997. The relevant thin capitalization provisions result in the rule that interest paid on loan capital that economically has the character of equity capital is not a deductible expense. The tax authorities indicate the allowed maximum amount of debt in relation to certain assets, e.g. 70% for shareholdings and 70% to 80% for immovable property.

Non-deductible interest is re-qualified as dividends for tax purposes.
Moreover, according to article 65 of the DBG, interest paid for hidden equity is not deductible.

The newest provision introduced concerns intercompany loans. This rule was introduced to make Switzerland more attractive as place of business.[200]
In fact, from August 1st 2010, intercompany loans are exempted from the dividend tax and the emission tax. This is put in place through a legal definition of those interest payments, which are not considered customer funds nor bonds (StV 16a) and VStV 14a).

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[199] THOMAS JAUSSI AND MARKUS PFIRTER AND COSTANTE GHIELMETTI, FREMDFINANZIERUNG IM SCHWEIZERISCHEN UNTERNEHMENSSTEUERRECHT, COSMOS VERLA 68 (2010).
[200] *THOMAS JAUSSI AND MARKUS PFIRTER AND COSTANTE GHIELMETTI*, supra note 228.

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Objective and subjective requirements

The starting point to determine the non-deductible portion of interest paid out by a Swiss corporation is the analysis of the part of loan capita to be re-qualified into hidden equity.

Hidden equity is the part of loan capital that third independent parties would not have granted. An initial step concerns the analysis of the financial data of the concerned company.

It must be noted that, as stated for by the Austrian legislator, also the Swiss system applies only for equity if it is granted by shareholders or closely related persons.
An objective condition concerning the loan contract itself states that the aforementioned rules apply only if the loan exposed to the business risk or the profit margin of the company because of the uncertainty of repayment of the loan due to subjective (will of the parties involved) or objective (financial situation) factors.

The general rule refers to arm´s length standards and therefore the question whether a third party would have granted a similar loan under identical conditions.

Circular 6 of 6th June 1997 lays down detailed thin capitalization rules for federal tax purposes. Accordingly, the total debt of a company may not exceed the aggregate value of the following assets of the company at the end of the year:[201]

- 100% of cash;
- 85% of receivables on goods and services;
- 85% of other receivables;
- 85% of inventory;
- 85% of other current assets;

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[201] *PETER BRÜHLISAUER AND JEAN ZIEGLER*, supra note 230.

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- 90% of Swiss and foreign bonds issued in Swiss francs;
- 80% of foreign bonds issued in foreign currencies;
- 60% of quoted shares, Swiss and foreign;
- 50% of other shares/investments in limited liability companies;
- 70% of participations;
- 85% of loans;
- 50% of machinery and equipment;
- 70% of operating real estate;
- 80% of other immovable property;
- 0% of expenses of incorporation,
- 70% of other intangibles.

As a rule consolidated by jurisprudence, financial companies may have a maximum debt/equity ratio of 6:1. These rules can be overruled by an arm's length assessment.[202]

Hidden equity

Concerning the part of debt economically considered as equity,[203] reference is made to the individual situation of the relevant company and not to a fixed ratio. The relevant figure is only the part of debt the company wouldn´t have been able to contract on the market.[204]

The single case analysis should make reference to those cases where a third party would no longer be prepared to grant loan capital and, one step before which conditions would be certainly applied to the loan at arm´s length.[205]

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[202] NYFFENEGGER, REPETITORIUM IM STEUERRECHT.
[203] *PETER BRÜHLISAUER AND JEAN ZIEGLER*, supra note 230, at 11.
[204] PETER *BRÜHLISAUER AND JEAN ZIEGLER AND MARTIN ZWEIFEL AND PETER ATHANAS (eds),* supra note 225, at 39; *PETER BRÜHLISAUER AND JEAN ZIEGLER AND MARTIN ZWEIFEL AND PETER ATHANAS (eds),* supra note 225, at 236.
[205] *PETER BRÜHLISAUER AND JEAN ZIEGLER AND MARTIN ZWEIFEL AND PETER ATHANAS (eds),* supra note 225, at 39.

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This makes it necessary to observe a series of general conditions such as the branch, the economic development and specific conditions such as the structure of the management.

Although it seems that also when the conditions given by the tax administration are respected, there could be a part of debt deemed as hidden equity, the academic world clearly says that these conditions are safe havens that guarantee the deductibility of the connected interest expense.[206]

Steps to verify the applicability of Sec 65 DFT are:

1. Isolation of possible hidden contributors-lenders: direct and indirect shareholder loans, backed securities, patronage letters, related parties;
2. Capitalization of the company: fair value of the assets;
3. Determination of the maximum debt: KS EStV Nr. 6 6.6.1997

This results in the rule that transactions between companies and their shareholders or affiliated companies not according to the arm's length principle are treated as hidden profit distributions article 4 VStG in connection with article 20 VStV.

Concerning case law, The Federal Supreme Court envisages hidden profit distribution (verdeckte Gewinnausschüttung) every time a company grants a benefit to its shareholder or a closely related person without receiving adequate consideration in return, under the condition that such a benefit would not have been granted to a third party under the arm's length principle, or would not have been granted in the same manner or amount and it is not doubted that the favourable treatment of the shareholder was apparent to the officials of the company.

For corporate income tax purposes, the deducted amount considered as hidden profit distribution is added back to taxable profits. Furthermore, withholding tax

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[206] ERNST HÖHN AND ROBERT WALDBURGER, STEUERRECHT I 492 (2002).

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may be levied on the value of benefits granted (see infra, chapter on participation exemption).

Concerning hidden equity contributions, the system works as follows: for some kinds of assets there is a maximum amount with respect to the portion of debt. This, as said before, is stated by Kreisschreiben nr. 6 estv june 6th 1997, which leads to a comparison of allowed debt for asset X and debt put in place. The resulting difference would represent hidden equity under the condition that there are loans by the shareholder. The remuneration of this loan would be considered as capital income and not as interest. The relevant cost would not be deductible on the level of the company.

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CHAPTER III. DISTRIBUTION OF PROFITS

1. The transplant of the "participation exemption model" in Germany

a. The transition from the imputation method to participation exemption

In order to escape the economic problems caused by the German Reunification, German politicians and academics started to concentrate on improving Germany's business location for the 21st century and globalization. One step in this project was to simplify the German tax system, making it more competitive and free from discriminations in respect to foreign investors. This was put in place with the first big tax reform of 2000. It was also intended to change all those special regulations that were rather timid attempts to reform the German tax system in the past. Tax base consolidation was another objective to be realized according to the introductory notes of the first tax reform.[207]

One of the tax reform's main objectives dealt with the taxation of partnerships. In fact the German legislator was basically driven by the desire to apply the equal taxation of business profits to partnerships and companies. Such equal tax treatment turned out to be the most problematic and politically controversial question of the entire law making process. The original proposal – made by a special commission appointed by the Ministry of Finance[208] to suggest a model for a new tax system - was to improve the equal treatment of taxation by granting partnerships the following privileges:

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[207] See Steuersenkungsgesetz – StSenkG – of October 28th, 2000 (BGBl I 1433, BStBl I S. 1428) and Unternehmensteuerfortentwicklungsgesetz – (UntStFG of December 20th, 2001, BGBL I S.3858, BStBl I 2002 S. 35).

[208] Bericht der Expertenkommission, Brühler Empfehlungen zur Reform der Unternehmensbesteuerung, BMF – Schriftenreihe, Heft 66, Bonn 1999.

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Partnerships and sole business owners should be entitled to opt for being taxed as companies ("Check the box");
In order to draw level with the tax burden by the 50% exemption method applied to dividends and capital gains on the disposal of shares: (i) profits should be taxed at a favourable rate of 25% and (ii) only one half of the net business income should be subject to income tax at the personal rate of each partner or owner;

partners and owners should be entitled to set off trade tax against in- come tax duty ("trade tax offset").

According to the draft bill[209] it was planned to introduce both the Check the box option and the trade tax offset. The Check the box option was withdrawn later on, leaving the trade tax offset as the sole specific relief for partnerships and business owners. This offset was denied to companies. This credit is a lump sum amount equal to 9 % of the business income, section. 34g (1) No. 1 German Income Tax Act.[210] Furthermore, the individual taxpayer could deduct his amount of trade tax from his business income in order to reduce his net income subject to income and trade tax.
In the view of the government, it appeared compulsory to introduce a major tax reform with respect to the German Corporate income tax system in order to make the German economy more competitive as an international business location.

b. Different kinds of participation exemption

For more than 20 years the so-called imputation system had been applicable to dividend income. Due to the Imputation System, shareholders could offset the amount of corporate income tax withheld by a company from dividends against their own income tax or corporate income tax duty. The Imputation System had been replaced by a new exemption system which does not allow the

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[209] See Steuersenkungsgesetz – StSenkG – of October 28th, 2000 (BGBl I 1433, BStBl I S. 1428) and Unternehmensteuerfortentwicklungsgesetz – (UntStFG of December 20th, 2001, BGBL I S.3858, BStBl I 2002 S. 35).
[210] dEStG, from now on dEStG.

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shareholders to offset the corporate income tax on dividends against the shareholder personal tax duty.
The new system, which had become generally known in Germany as the “50% exemption method” and then as the “partial exemption method”, is applied both on the level of the company and its shareholder.
Today profits of a company are subject to a tax rate of 15% without regard to the source of income, pursuant to Section 23, subsection 1 dEStG. The same rate of 15% applies to profits earned by foreign companies through their German permanent establishments. Corporate income tax is a final burden leading to non-domestic credit or refund. Since the shareholder is no longer allowed to offset the amount of corporate income tax against his income tax duty, there was a risk of double taxation of corporate profits distributed to the shareholder.

In order to avoid such a double taxation on the level of both the company and its shareholder, only one part of the individual shareholder’s dividend is now subject to income tax.[211] As a consequence, (i) a corporate income tax rate of 15% on level of the company plus (ii) income tax on 60% of dividends results in total tax burden on such income that approximately equals to the amount of ordinary personal income tax borne by individuals with business income.

The partial exemption method means that the full tax burden will not be borne unless the company makes a full distribution of its profits. If the company does not distribute its income, the tax burden is limited to the 15% corporate income tax plus trade tax and solidarity surcharge (altogether approximately a tax rate of 30% to 35%, depending upon the rate of the trade tax, which depends on the municipality where the company is located). As a consequence, a company is benefiting from this favourable taxation if it uses profits for financing investments instead of making distributions and taking additional capital or outside loans.
Provided that profits ploughed back are subject to a lower tax burden than profits distributed to shareholders, many shareholders may prefer to have their shares grow in value rather than to receive current dividend income. This will

[211] Actually 60 percent pursuant to Section 3c subsection 2 dEStG.

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be particularly attractive if they are able to realize this growth in value through a subsequent tax exemption or lower taxed sale of their shares.

It may also be worth thinking to pay back part of the company's share capital instead of distributing a dividend, if there are many individuals with a shareholding of less than one per cent.[212] Even if it is decided to distribute dividends, shareholders have to take into account that tax rates might be reduced in future, so it might be preferable for many shareholders to receive dividends later rather than sooner.

Additionally, as a safety procedure,[213] dividends of a German company will continue to be paid under deduction of a withholding tax, although this is reimbursed in most cases. The respective rate is 26,5% (25% withholding tax plus solidarity surcharge).[214]

Dividend withholding tax will be withheld from the gross dividends distributed, even though only 60% of the dividend income is to be taken up into the taxable income of an individual and effectively 5% of it is to be considered in case of a company as a shareholder. This ensures that any profit distributed bears income and corporate income taxes of at least 30%.[215] This burden can be partially reduced in the hands of domestic shareholders, since the withholding tax will be fully credited against their income or their corporate income tax duty. However, the 15% corporate income tax charge remains a final burden.
The German parliament passed a tax-reform plan in July 2000 that applies for 2001-05. The reform, which eases both corporate and individual tax rates, was effective from January 1st 2001. An additional step of the tax reform, which the government decided in June 2003 to bring forward by one year to January

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[212] The pay back of share capital is tax exempt, if the shareholder owns less than one percent of a company's share capital, according to Section 17 dEStG.
[213] See *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, who affirm that this measure was principally put in place because of the circumstance that corporations hardly can evaluate if their shareholders are within the scope of application of the withholding tax for capital or not (*Kapitalertragsteuer*).
[214] Section 43a (1) note 1 dEStG, Solidarity Surcharge Act, from now on SoliG; Solidarity Surcharge is an additional tax raised based on the corporate tax due.
[215] Dividend, netted from 15% Corporate Income Tax, multiplied by 26,5% withholding tax, is equal to 30%.

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2004, applies only to individuals' income taxes, not to corporate income taxes. But many small and medium-sized companies are organized as partnerships and, therefore, profits are taxed at the level of the partners at individual rates; hence they will benefit from lower taxes. The government estimates that the annual tax relief for such companies will be in total €10bn.

Before 2001 German corporate income tax was calculated according to a split system: 40% on retained profits and 30% on distributed profits. It also employed an Imputation System under which domestic shareholders were entitled to credit the full amount of corporate income tax against their income tax duty. Foreign companies with income from German business activity were subject to a tax of 40% whether income was distributed or not. Beginning with the 2001 tax year, a single tax rate of 25% and the 50% exemption system replaced this method.

However, the tax reform caused a decrease in federal tax revenues in 2001 and 2002. The government had evidently underestimated the ability of companies to use possibilities to reduce their tax duties.[216] In fact, when Germany moved from the imputation system to the Participation Exemption method in 2001, a complex mechanism of baskets (on a 15-year basis) was introduced to trace at which rate the profits had been taxed under the imputation system and a corresponding credit was granted to the shareholders.[217] It closed a major loophole on the reimbursement of tax credits in May 2003.
Germany has a preliminary budget deficit of €38.6bn in 2003, €4.8bn less than expected. In order to rein in the soaring deficit, the government in November 2002 proposed a host of measures to cut back tax reductions and exemptions. Both Bundesrat and Bundestag passed a trimmed-down version of the Tax Benefits Reduction Act in May 2003. It had to bring in additional annual tax revenue of €4.4bn, instead of the original €16bn that the government had desired. Intended innovations, that were dropped in the final legislation would

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[216] The reduction of the respective tax duties was the consequence of a massive use of tax credits originating in maturated dKStG baskets with respects to the former applicable imputation system.
[217] Gianluca Russo, *International aspects of the proposed corporate tax reform – a comment*, EUROPEAN TAXATION 304 (2003).

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have affected private investors as well (such as taxes on capital gains from the sale of shares and bonds) and would have established a minimum corporate income tax and stricter depreciation rules.

Innovations included in the final law, effective with the financial year 2003, are as follows: a three-year moratorium (until end-2005) on the reimbursement of corporate income tax credits, after which any reimbursements will be limited to one-sixth of annually distributed profits; the abolition of multiple parent consolidated tax groups (Mehrmütterorganschaft); limits on loss deductions for silent partnerships, so that companies that are silent partners in another company can offset losses only against income from the same company; extended documentation requirements about transfer pricing for both domestic and international companies; and Elimination of double-tax treaty protection for income from subsidiaries in tax havens under the Controlled Foreign Companies ACT rule (Hinzurechnungsbesteuerung).[218]

Further innovations, effective with the financial year 2004, were as follows: investment-related deductions: according to section. 8b (5) dKStG, 5% of the dividends received from foreign subsidiaries at the level of a company are treated as deemed non-deductible business expenses. This rule shall be extended to dividends received from domestic subsidiaries and to capital gains realized upon the sale of foreign or domestic subsidiaries. In turn, actual business expenses of the parent company (e.g. financing expenses in the limitation of the thin capitalization rule) related to the tax-exempt income can be fully deducted. The new regulation is applicable from the fiscal year 2004.

For reasons of easier comprehension of the legal system in Germany, it has to be added that both the legal system and the German tax administration have always given relevant importance to the economic relationship between a company and its shareholders with respect to contracts being made between the aforementioned companies, whether they are individuals or, again,

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[218] SCHWEDELM ROLF IN STRECK MICHAEL, KSTG – KOMMENTAR (2004), DÖTSCH EWALD AND JOST WERNER AND PUNG ALEXANDRA AND WITT GEORG, DIE KÖRPERSCHAFTSTEUER, KOMMENTAR ZUMKÖRPERSCHAFTS-STEUERGESETZ 116 (2004), OTTO GERD LIPPROSS, BASISKOMMENTAR ZUM KÖRPERSCHAFTSTEUERGESETZ (2004).

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companies. The clear definition of the expression hidden profit distribution[219] from a legal point of view and from the viewpoint of jurisprudence[220] is important to understand the logic underlying the German tax system in more detail (*see infra*).

Because of major changes in German tax legislation, the thin capitalization rules had been amended for fiscal year 2004 (fiscal year 2005 for company with a business year deviating from the calendar year).
The German Thin Cap Regime was introduced also to German resident shareholders financing their company with shareholder loans, this at the same time as the classical system with regards to the taxation of profits distributed by companies and the relevant capital gains. This circumstance has an interesting effect on the valuation of the respective tax model circulation. The former non-deductibility rule with effects only on foreign investors became also applicable to the whole shareholder financing put in place by German resident shareholders.
The process of introduction of this new German Thin Cap Regime was accelerated by various decisions made by the European Court of Justice and followed a certain development present also in other tax systems in Europe.
The German legislator had to face strengthening opposition by the ECJ against discriminating rules with respect to the treatment of foreign investments in Germany.[221] It is, for instance, significant that the forecasted measures to be put in place by the German tax legislator for tax reform purposes from now on are directed following a similar philosophy (for a more detailed explanation on actual tax reform plans *see infra*), being concentrated on deductibility issues regarding interest and financial components of leasing payments.

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[219] Verdeckte Gewinnausschüttung according to section 8, subsec. 3 (2) dKStG.
[220] According to the BFH: Constant interpretation given by the highest federal court BFH: Hidden profit distributions in the sense of sec. 8 III 2 dKStG are all reductions (or improvements not carried forward) of the company's assets, which are caused by the relationship to the company's shareholders, having an effect on the company's taxable income and not equal to an open distribution of profits.
[221] see EJC: C-292/04.

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Double taxation and discrimination avoidance

At this stage, the determination of a company's residence normally adopted by the German tax administrations is to be clarified in a brief and concise way. More precisely, the location of the management of a company is a rather difficult question.[222] Section 10 of the German Tax Code defines residence as the central point of the management of a business. This definition is of particular importance if a German company is managed from abroad or if a foreign company is managed from Germany. Since the text of the statute law is rather short, its meaning must be interpreted by a large amount of case law for the subject.
German case law does not treat a foreign company managed from Germany as a "*company within the meaning of Section 1 (1) KSTG",* because not all the German formalities of formation, and especially those with respect to the registration of the company with a German trade registry, have been complied with. The consequence drawn by German case law is that such a company, if resident in Germany at all, is to be taxed as a company within the meaning of Section 1 (1) No. 5 KSTG. However with its Centros decision in 1999, the ECJ held that companies validly formed abroad, but effectively managed from Germany, should be recognized in Germany as legally permitted. As a consequence such foreign companies are subject to unlimited corporate income taxation in Germany under Section 1 (1) No. 1 dKStG, rather than under Section 1 (1) No. 5 KSTG, the previous German view.

Another discrimination of foreign investors and their investments may be caused by the German withholding tax system on dividends, which always are considered relevant by taxpayers, as they have the most direct influence on a company's liquidity.
As concerns Germany, the typical withholding tax (for the specific treatment of branches, *see* infra), i.e. the tax on dividend income,[223] is to be defined as prepayment, which is fully creditable against both personal and corporate

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[222] HELMUT DEBATIN AND DIETER ENDRES AND MARIUS MÖLLER: UNTERNEHMENS-BESTEUERUNG IN DEUTSCHLAND 80 (2001).

[223] Kapitalertragssteuer according to Section 43, dEStG, BStBl I 2006, 2878.

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income tax, if the respective taxpayer is subject to unlimited taxation in Germany. Withholding tax is due immediately after the board of shareholders decides to distribute profits of their company, and can be credited by filing a relevant corporate income tax return. The prescribed withholding tax rates are: 20% plus solidarity surcharge on dividends distributed to German resident and 0% on dividends distributed to European parent companies under EC Parent/Subsidiary-Directive (PDS), if the parent company has been at least a 15% shareholder for a minimum period equal to at least 12 months.
The PDS exemption can also apply to 10% shareholding parent companies resident in another EU Member State, if this EU Member State itself grants the exemption to German resident parent companies holding only a 10% share. The parent/subsidiary regime is not applicable to dividends received by companies which are subsidiaries of EU resident persons unless the recipient can prove that the parent company was not established for the sole purpose of benefiting from the PDS exemption. This proof has an effect only, if the shareholder himself meets the same requirements set out under the PSD, in addition to the requirements to be met by the respective subsidiary and parent company under the PDS.

With respect to tax rates, and especially effective tax rates, it should be added that on the level of the profit distributing company 15% corporate income tax plus 5.5% solidarity surcharge, giving effective rate of 16.67%, is levied. Municipal trade tax on income is also payable at rates fixed by each municipality independently. Trade tax is treated as a deductible expense for corporate income tax purposes as yet. The average municipal rate is 400% (corresponding to an average trade tax rate of 16.67% and an overall effective corporate income tax rate of 30.646%). The municipal rate is higher in large cities – e.g. a municipal rate of 460% leads to a trade tax rate of 18.7% and an overall effective corporate income tax rate of 33.14%.

It is remarkable that Instructions by the Ministry of Finance introduce the German Participation Exemption by affirming that "[…] Participation Exemption is applicable to all income linked to participations, whether deriving from Germany or abroad, and irrespective of whether deriving from participations in companies, partnerships and trusts in the form of Section 1 and 2 KSTG. No minimum participation is required."

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Before the introduction of the new legislation in 2001, the German tax law was potentially in danger of being considered as counteracting the principles of the Treaty of the European Union.[224] In fact, under the former tax law, capital gains realized in Germany were fully subject to tax, but capital gains realized by sale of shares held in foreign companies were tax exempt.[225] This had the consequence that German participations were treated less favourable than foreign ones. Also the systematic implication that non-resident companies were not able to impute withholding taxes on dividends of their German subsidiaries and were consequently subject to double taxation, while German companies could impute withholding taxes, was likely to be in conflict with the freedoms granted by the EU Treaty.[226] It can be affirmed that the elimination of the Imputation System and the introduction of a classical exemption system has its reason and justification partially in the possible violation of the EU Treaty. An open issue in this field is the potential discrimination between resident and non-resident holding companies, with respect to withholding tax applied in Germany. Although there might be discrimination in the circumstance that the German withholding tax (i) might not be applicable to minority shareholders under some double taxation treaties between Germany and certain countries but (ii) is applicable to other non-treaty protected minority shareholders with a material impact on such shareholders' liquidity. This because the capital withholding tax is built as a security measure that has no influence on the actual level of taxation as it is fully reimbursed or credited against regular corporate income taxation.

Irrelevance of fiscal residence of the shareholder for the concern of dividend taxation

The aforementioned is valid also for inbound profit distributions. No particular observations were raised in this respect during the debate about the new corporate income tax system in Germany as the treatment of foreign dividends,

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[224] Ottmar Thömmes, *Der Betrieb*, 775 (2001).
[224] See Thömmes, supra note 253.
[225] DÖTSCH EWALD ANS JOST WERNER AND PUNG JOACHIM AND WITT GEORG, DIE KÖRPERSCHAFTSTEUER 9 (2008).
[226] CARLO GARBARINO, MANUALE DI TASSAZIONE INTERNAZIONALE 795 (2009).

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distributed to the German parent company was the same (full exemption) as before the tax reform. The problems were linked almost exclusively to outbound dividend income.

Nonetheless, is it remarkable that by means of the reforms put in place in Germany in 2001, the same treatment of dividends paid by resident and non-resident subsidiaries is following recent tax reform developments put in place by other European countries. If the shareholder is resident abroad, the dividend withholding tax will be reduced according to the relevant double taxation treaty. If the shareholder is a parent company resident in another EU country, the shareholder can apply for a withholding tax exemption.

Profits repatriated by a permanent establishment to its foreign head office are not subject to any form of withholding tax or branch taxation.

By means of the *Steuersenkungsgesetz* the German Corporate Income system was transformed from a full Imputation System into a classical system with a full exemption on the corporate level and a 40% exemption on the level of the individual shareholder.[227] This new German Corporate income taxation system, formerly called "Half Exemption Method"[228] that comes from the 50% exemption as mentioned above, is now called "partial exemption method" due to its modified percentage with reference to the taxation of distributed profits. With respect to individual shareholders only 60% of distributed profits are subject to individual shareholder's tax assessment. On the other hand dividends distributed to other companies are 95% tax exempt under this new taxation system. This has the consequence that profits are subject to corporate taxation almost only once among chains of participation until the profit is transferred outside the companies' sphere and flows to the level of the individual shareholder. The introduction of the new system was not carried forward without application problems and transitional rules.

The most important consequence of this innovation is caused by its better compatibility with the developing internationalized economic spectrum. While before the introduction of the Participation Exemption for dividends it was extremely difficult to grant foreign shareholders credits in the same way as resident shareholders in the Imputation System, the new Participation Exemption System provides for a fairer treatment of foreign and domestic

[227] See Instructions by the Ministry of Finance, BMF Circular, 28.04.2003, BStBl I 2003, 292.
[228] Halbeinkünfteverfahren.

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shareholders and is much less complex. It is also worth mentioning that the tax system became very open for foreign investors, because the German tax legislator did not exaggerate in introducing new requirements for the application of the Participation Exemption. The scope of application is very wide and is inclusive of a vast number of foreign companies. The new system does not present an exclusive list of tax subjects which are allowed to apply for the Participation Exemption, but simply excludes some shareholders resident in tax havens. Shareholders resident in tax havens have the possibility of being admitted to the Participation Exemption rule by proving that being resident in the tax haven was not only based on the idea to benefit from lower taxes. Respective shareholders have to prove that they also had economic reasons for being resident in tax havens. Germany has always been very concentrated on incentivizing German investments abroad and that had an effect on the tax system.[229] Now it appears that also investments from abroad should benefit from a positive legislation.[230]
According to Section 8b and Section 37, subsection 3 there is a transitional period of 18 years in which the rule to be applied is the following: income exempted by the new Participation Exemption provision that has been hit by former tax reductions at the level of the paying company could be taxed for the amount arising from the difference between the reduced tax rate.

c. Scope of the exemption and definition of equity/dividends

Section 8b dKStG states that gross dividend income within the meaning of Section 20 EStG, Numbers 1,2,9 and 10 lit a) does not have to be added to a company's taxable income. For a detailed analysis of the types of distribution included in the scope of the provision, *see infra.* Before the introduction of the so-called Tax Reduction Act 2001[231] an exemption with respect to profit distributions between companies and their corporate shareholders was granted

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[229] E.g. the circumstance that profits from abroad, distributed to German corporate shareholders are exempt since 1998.
[230] See Protokollerklärung Korb II.
[231] Steuersenkungsgesetz – StSenkG – of October 28th, 2000 (BGBl I 1433, BStBl I S. 1428 and Unternehmensteuerfortentwicklungsgesetz – UntStFG of December 20th, 2001, BGBL I S.3858, BStBl I 2002 S. 35.

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only to German shareholders detaining participations in foreign companies. This was put in place with the intention of elevating Germany's attractiveness as a holding company location.[232] Due to the change in the taxation of corporations by the Tax Reform in 2000, the scope of application was enlarged, now including participations in resident companies as well.

Contrary to the treatment of participations held by individuals, German tax law does not require a special legal form of business activity, in which a parent company trying to benefit from the Participation Exemption has to hold its shares. Specifically, only a list of the companies which admitted to be benefiting from the exemption in their nature as subsidiary is delivered.[233] The German legislator refers to Section 1 and 2 dKStG which lists the subjects subject to corporate income tax, with the difference that Section 8b dKStG includes all foreign companies as well. It is a closed dKStG list, which does not allow interpretation for subjects not explicitly mentioned in the provision itself. In fact, no minimum participations or holding periods are required in order to apply for the Participation Exemption Method.

This fact creates some problems, as it is common practice in Germany to use foreign legal forms for German resident enterprises in order to avoid the strict incorporation rules and the rigid formal requirements in respect to the management of a German company. The German tax administration reacted to this development and published a circular,[234] which referred to the use of an US LLC with respect to German tax law. It is clear that if German tax legislator adopted a limited list of persons benefiting from Section 8b, subsection 1, this adoption would cause grave problems, since such a limited list could not keep up with the economic development and the introduction of new forms of foreign companies In this field, the German tax administration is always behind the current developments

[232] OTTO GERD LIPPROSS, BASISKOMMENTAR ZUM KÖRPERSCHAFTSTEUERGESETZ, marginal reference 1 (2006).
[233] BMF – Circular of April 28th, 2003, BStBl I 2003, 292, Tz 4.
[234] BMF – Circular LLC.

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Participated companies

As said before, the German Participation Exemption provision, i.e. Section 8b, subsection 1 dKStG, does not contain specific conditions for the application of the rule with respect to the nature of the subsidiary company. Therefore the rule stays applicable for all companies subject to corporate income tax, both resident and non-resident ones, whatever their type of activity, form of incorporation or level of participation.
As an example of the general application of the Participation Exemption Method, capital gains from the disposal of shares that had previously been written off to fair market value are fully taxable at the normal corporate income tax rate. Passive income from a foreign subsidiary must be subject to tax of at least 25%.[235]
With respect to companies which are resident in tax havens, it has to be mentioned that in cases of interposed companies between foreign companies and German shareholders, the profits of the foreign company which are attributable to the German shareholders according to Section 10 AStG,[236] assuming tax transparency of the interposed company, although systematically included in the exempted profit distribution according to Section 8b, subsection 1 dKStG and consequently Section 20, subsection 1 (1) EStG, are not within the scope of application of the participation provision[237]. This is valid for profits realized in force of contractual agreements between interposed company and German resident company. In case of dividends paid to interposed companies, no attribution to the shareholder can be put in place.[238]

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[235] Section 7ff AStG, Section 10 AStG.
[236] Aussensteuergesetz in the publication of September 8th, 1972 published in BGBl I 1972, 1713;
[237] *HELMUT DEBATIN AND DIETER ENDRES AND MARIUS MÖLLER*, supra note 251.
[238] Active income according to Sec. 8 Subsec. 1 Nr. 8 AStG, not attributable to the German resident shareholder according as of Sec. 10 AStG.

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Shareholders

We stated above that under the concept of the Participation Exemption Method, dividends and other distributions on shares held in a company are partially exempted from further taxation in the hands of shareholders.[239]

The German Income Tax system presents different categories of shareholders benefiting from the tax exemption on dividends, either in an almost full or a partial way. The first differentiation is made between the natures of the shareholder: companies benefit from a 95% exemption for dividends received while individuals benefit only from a 40% exemption. No differentiation is made between individuals receiving profits within a business activity or private investors: a so called 40 exemption is granted to both.
Furthermore, resident shareholders and non-resident shareholders are treated equally as follows: no differentiation is made at this stage (except for the particular conditions prescribed under the CFC regime of the AStG for participations held in non-resident companies benefiting from a material lower taxation with respect to the German corporate income tax rate, even though dividends do not fall within the scope of this rule; see infra). An equal treatment of resident and non-resident corporate companies is also made by the so called "type comparisons".[240] This type comparison has to be applied in order to check whether the foreign company has a legal form corresponding to one of the typical legal forms existing in the German Company Act and therefore would have the right to fall within the scope of application of the corporate income tax.
With regards to corporate income tax the legislation itself does not contain specific requirements for the type comparison. The type comparison is case law in order to find out whether a legal form of a foreign company is similar to German resident companies within in the meaning of Section 1 and 2 KSTG.[241]
The Participation Exemption Method applies both (i) to all corporate companies

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[239] *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 18.
[240] *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 14.
[241] *MANFRED MÖSSNER AND SIEGBERT SEGER*, supra note 282, marginal reference 2 and Streck: *Körperschaftsteuergesetz*, Beck-Verlag, München, 2005.

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within the meaning of Section 1 and 2 dKStG and to (ii) (due to the type comparison) similar foreign companies. Furthermore, it is acknowledged by the Ministry of Finance's circular of April 28th, 2003[242] that the Participation Exemption Method applies to all companies subject to unlimited and limited German Corporate Income taxation. This is agreed upon by the academic world[243] which describes applicability for both resident and non-resident shareholders and participated companies, irrespective of their form of company, type of profit accounts, activity or amount of the participation.[244]
Thus individuals, sole traders or individual members of partnerships of individuals will only be subject to tax with half of the dividend received to income tax (50% exemption method). The other half is tax exempt (Section 3 Number 40 EStG). Resident companies will receive dividends exempt from corporate income tax (95% exemption of dividends).
Dividend ranks as business income of the recipient if shares are held as business assets. Furthermore a Participation Exemption also applies for trade tax purposes. This will lead to an actual trade tax saving whenever the conditions for the trade tax exemption of the income (Section 9 Numbers 2a and 7 German Trade Tax Act)[245] are met.
The Participation Exemption Method applied from 2002 (i.e. for openly declared dividends for 2001), or later if the company paying the dividends does not have the calendar year as its fiscal year.

Section 8b, subsection 1 states that receipts within the meaning of Section 20, subsection 1, Nos. 1,2,9 and 10 letter a of the EStG are not part of the taxable income. The Participation Exemption Method does not require a minimum holding period for the exclusion from the tax assessment of profits received from participated companies.[246] This is applicable both to domestic and foreign

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[242] BMF – Circular of 28.04.2003, BStBl I 2003, 292, Tz 4.
[243] Francesca Cirrincione and Francesco Spinoso, *Società holding e l'istituto della cd. Participation exemption vigente in Belgio, Lussemburgo, Francia e Germania*, FISCALITÀ INTERNAZIONALE 84 (2006).
[244] *MANFRED MÖSSNER AND SIEGBERT SEGER*, supra note 282, marginal referenced 2 and MICHAEL STRECK, KÖRPERSCHAFTSTEUERGESETZ (2005).
[245] GewStG, from now on TTA – D.
[246] Francesca Cirrincione and Francesco Spinoso, *Società holding e l'istituto della cd. Participation exemption vigente in Belgio, Lussemburgo, Francia e Germania*, FISCALITA INTERNAZIONALE 84 (2006).

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participations. It should be added that no minimum participation is required. A foreign participated company must be subject to the corporate income tax in its country of residence to benefit from the Participation Exemption, but there is no indication of a minimum level of taxation.
While there is no restriction with respect to the activity of the participated company, there has to be a so called type comparison put in place between the foreign company's form of company and the German legal system.
There must in fact be correspondence between to the two companies, or at least there must be a certain amount of similarity with reference to the form of company of the foreign company and the typical forms of German companies, listed in the KSTG.[247] It can be stated in this respect that in fact not all dividend income from participations in companies are tax exempt, since 5 % of the distributed profit is deemed to be non-deductible expenses, whether the real expenses were higher or lower than that limit. This has the consequence that the exemption granted to corporate shareholders is equal to 95%.

No specific conditions

Profits realized by a company and accordingly taxed on the corporate level have to bear an economical double taxation if taxed again on the level of the shareholder. This kind of double taxation is tried to be justified by means of the circumstance that company and shareholder are formally two different legal companies.[248] This of course is economically not satisfying, as it is clear why profits should be taxed on the corporate level (companies are independent companies with legal personality which participate on their own in the market competition and therefore should be taxed according to their performance). It seems not be understandable why the event of profit distribution determines an additional taxation of the same profit. Industrialized countries have to face this risk of double taxation, hence these countries use two different systems for the relief from economical double taxation. These countries are all participating in the OECD. Those systems are either (i) Participation Exemptions Systems or (ii)

[247] Einkommensteuergesetz in the form of BGBl I p. 4212, corrected 2003 I p. 179.

[248] MARKUS REICH, DIE WIRTSCHAFTLICHE DOPPELBELASTUNG DER KAPITALGESELLSCHAFTEN UND IHRERE ANTEILSEIGNER (2000).

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Imputation Systems. The recently introduced system for corporate income taxation states the transition from a full Imputation System to a Participation Exemption system. Losses that cannot be offset against gains in any given year may be carried forward indefinitely and carried back for one year. From January 2001 only losses up to €511,500 may be fully carried back into the previous year.
Losses that cannot be offset against gains in any given year may be carried forward indefinitely. A minimum taxation rule has been implemented for income tax, corporate income tax and trade tax purposes according to which losses may only be offset against positive taxable income, to €1m without limitation per year. A positive taxable income exceeding €1m in a year may only be offset against existing tax-loss carry-forwards in the amount of 60%. The new regulation applies from fiscal year 2004 onwards.

From an economic point of view, profit distribution can be defined as remuneration of those persons who, in their position as shareholders, made an investment in the capital of a business enterprise in the legal form of a company. Such a remuneration is linked to the economic profit or loss of the enterprise, and this dividend remuneration is not similar to other remunerations e.g. interest on loan between the company and other persons. From a legal point of view, a dividend is the part of the company's profit distributed to the shareholders in proportion to their participation in the company's share capital.
Taxable dividend income is depending on the determination of the distributable profit pursuant to applicable law.[249]
According to Section 8b, subsection 1, there is a closed list of profit distribution types which fall under the German Participation Exemption rule. Furthermore hidden profit distributions[250] fall within the scope of the Participation Exemption Method.

[249] Handelsgesetzbuch, Section 67.
[250] Definition of VGA according to BFH, above cited.

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Before the tax reform and, more specifically, during the application of the former Section 8b, it was doubted that Participation Exemption Method applied also to hidden profit distributions.[251]
A particular treatment applies to those distributions whose source is the equity for tax purposes of the respective company (Steuerliches Einlagekonto). The sale of dividend coupons and claims connected to the material right to receive dividend distributions is also exempt according to Section 8b, subsection 1. No exemption is granted to income from leasing operations connected to shares. Income from operations as of Section 20, subsection 9 and 10 is exempt. Withholding tax is creditable against corporate income tax of resident taxpaying companies, while it is considered definitive for foreign taxpayers, with several exceptions under double taxation treaties and the EU Parent – Subsidiary – Directive.

Section 20, subsection 1 N. 1), 2), 9) and 10) dKStG lists income considered exempt according to Section 8b, subsection 2 dKStG. It is worth noting that Section 20 ITA – D represents a comprehensive catalogue of income definable as capital profit under the German tax law.[252] Not only does the aforementioned section list certain specific types of income to be considered as income from capital, but it also puts in place a definition making possible an analysis of profit types, not explicitly included in the provision.
In fact, subsection 9 of the relevant Section 20 dEStG states that income, similar to the abovementioned cases, is considered income from capital. The comparison has to be put in place analysing the nature of the observed income: it has to be linked with a right to participate in the distributing person's profits.

The approach demanded by the German tax legislator can be defined as according to the principle of *substance over form.*[253]

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[251] MANFRED MÖSSNER AND SIEGBERT SEGER, KÖRPERSCHAFTSTEUERKOMMENTAR, § 8B BETEILIGUNG AN ANDEREN KÖRPERSCHAFTEN UND PERSONENVEREINIGUNGEN (2005) marginal reference 64.
[252] *MANFRED MÖSSNER AND SIEGBERT SEGER*, supra note 282, marginal referenced 70.
[253] HELMUT DEBATIN AND DIETER ENDRES AND MARIUS MÖLLER, supra note 251.

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Shareholders: different sets of rules with regard to their nature

Under the Imputation System, the global taxation with regards to profits distributed by German companies depended on the place of residence of the shareholder and the source of income which was used to distribute the dividend. Before the introduction of the 50% exemption method, individuals subject to limited income taxation were not able to obtain a tax exemption or could not offset corporate income tax paid with regard to their participation in a German company. The new system was introduced also because there were some doubts regarding the compatibility of this legal treatment with European law.[254]

In consequence of the 50% exemption method, individuals as shareholders may only deduct one half of any expenses directly connected with the dividend (e.g. interest expense – Section 3c, subsection 2, EStG). For the application of Section 3 c, subsection 2, EStG it does not matter when this dividend is distributed. The respective costs remain therefore deductible only as to one half even if they were incurred in periods in which no tax exempt income is actually received.

Dividends not received through a business activity

German resident partnerships benefit from the same tax treatment as German resident individual shareholders holding shares in participated companies.
It does not matter whether the subsidiaries are resident in Germany or not, except for the case of subsidiary companies resident in tax havens, which are subject to a set of rules included in the AStG.
Furthermore, tax treatment concerning the taxation of income from participations has never depended on the circumstance whether dividends were received within or outside a business activity put in place by the shareholder.

[254] See ECJ, *Verkooijen*, C – 35/98, of June 6th, 2000.

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The German taxation of profits distributions presents a differentiation only with respect to the type of person receiving the payment. As mentioned above the recently introduced system for taxation of profits distributed to shareholders, i.e. transition from an Imputation System to a shareholder relief or classical system, include rules both for shareholders being individuals as well as shareholders being companies. It has to be added that no special rule is stated for the taxation of members of a partnership holding participations in companies or other partnerships, as they are taxed under the same set of statutory rules as individual investors holding those participations. At this stage, the only innovation introduced by the tax reforms of the year 2001[255] concerns the taxation of profits from participations in companies resident in Germany, held by companies who are subject to German corporate income tax.
As mentioned above, foreign companies participating in German companies or partnerships were not entitled to credit their tax amount against the taxes the German company had to bear under the former Imputation System.
Under the new Participation Exemption Method, foreign corporate shareholders are no longer hit by double taxation concerning dividends received from their German subsidiaries. This innovation, introduced because of doubts about the compatibility with EU law referred to the former legislation, is revolutionary only for foreign legal persons, as foreign individuals holding participations in companies liable to German corporate or income tax, had been able to credit the taxation borne by the subsidiary also before the renewed provisions.

Since 2001, the comprehensive taxation referred to corporate profits received by individuals subject to income tax has been the following: at the corporate level, profits realized by the company are subject to a standard tax rate of 25%, independently from the decision to distribute or to carry forward these profits, as prescribed by Section 23 subsection. 1 EStG, if distributed, the profit grants from a standard exemption rate on the level of the personal shareholder, equal to 50% of the net profit amount[256] received. This leads to an effective tax rate which depends on the marginal tax rate of the shareholder: individuals bearing an income tax rate equal to or higher as 40% benefit from a lower taxation than under the former Imputation System, individuals with a tax rate

[255] So called Korb II Act, as published in BGBl p. 4145.
[256] Section 3, Nr. 40d – I dEStG-D.

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lower than the aforementioned have a higher effective tax rate than under former Imputation System.[257]

These differences in the effective tax rate referred to the shareholder derive from the circumstance that, because of the standard corporate income taxation on the company's level, the marginal income tax rate is no longer considered according to its exact amount, but by means of a standard exemption equal to 50% of the received profits.[258]

It is understandable that same authors consider such a construction as running against the "Leistungsfähigkeitsprinzip".[259] The Leistungsfähigkeitsprinzip is a constitutional law principle which rules to tax individuals taking into account their ability to pay taxes; this principle is also confirmed to be applicable to tax law by the German Constitutional Court and the German Supreme Tax Court.[260]

In cases of profit distributions versus an asset managing partnership whose interests are held by a company, Section 8b, subsection 2 is applicable because of the "partial view principle.[261]

In times before the introduction of the Participation Exemption Method, such a structure had no effects on the taxation of the company profits and the interposed partnership had no tax effect. Nowadays subsection 6 of Section 8b dKStG explicitly states that interposed partnerships do not have effects on the application of the 95% exemption granted to the parent company. This means that the parent company benefits from the 95% exemption also if its profits are distributed through subsidiary partnerships and to the parent companies.

Dividends distributed by companies resident in fiscal havens

Similar to other countries, the German tax system has statutory rules which apply to profits paid to companies resident in tax havens and their shareholders resident in Germany, in order to limit the possibility to erode the German corporate income tax base. At this stage the relevant system of provisions is

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[257] *KLAUS TIPKE AND JOACHIM LANG*, supra note 165, marginal reference 16.
[258] *KLAUS TIPKE AND JOACHIM LANG*, supra note 165, marginal reference 16.
[259] Principle stated by Section 3 of the German Constitution.
[260] BVerfGE 84, 348, 363; BVerfGE 96, 1, 6; BVerfGE 99, 88 and BFH BStBl. 1999, 450.
[261] Bruchteilsbetrachtung according to Section 39, Subsection 2 (2) Tax Code, which states that a partnership controlled by a corporation distributes its profits automatically to the partner in proportion to the participation.

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included in the AStG. It has to be mentioned that the dKStG itself does not include specific rules which apply to shareholders who are resident in a tax haven, but the applicable rule must be seen in Section 2 and 7 AStG.
These provisions give a direct definition of "regions benefiting from a tax rate materially lower than the German one" (Section 2 – 6 AStG). Furthermore with respect to interposed companies, resident in countries with a lower taxation, Sections 7-14 AStG state that profits distributed to such interposed tax haven residents, which are controlled by (i.e. shareholding of more than 50%) individuals resident in Germany, lead to a corporate shield deemd transparent with the consequence that the relevant profits is taxed as if directly received by the German resident shareholder.

Profits received by those foreign companies and not distributed to their shareholders are deemed to be distributed,[262] no matter if really paid out or carried forward by the foreign company. As this rule is not limited to countries resident outside the EU, there are strong doubts about its compatibility with EU law,[263] also under the circumstance that the ECJ often raised doubts, but without declaring the rule as openly incompatible with the European freedoms.

The partial exemption method does not distinguish between domestic and foreign dividends. Thus dividends from foreign companies received by German resident individuals as income are only taxable as to 60%, regardless of whether they rank as investment income or income from trade or business.
Foreign withholding taxes deducted from the dividend may only be deducted from the German income tax, if the respective tax is due because of income from the same country (Section 34c, subsection 2, EStG). Since the foreign withholding tax is levied on the entire dividend, the original draft bill sought to have this amount creditable against German income tax but not to grant any

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[262] BIRGIT HADENFELD, DIE HINZURECHNUNGSBESTEUERUNG NACH DEM DEUTSCHEN AUSSENSTEUERGESETZ VON EINKÜNFTEN AUS DEUTSCHEN QUELLEN (2001); MARKUS FRISCHMUTH, INTERNATIONALE UNTERNEHMENSTÄTIGKEIT UND DEUTSCHE HINZURECHNUNGSBESTEUERUNG (2003).
[263] Georg Sass and Jens Schönfeld *Hinzurechnungsbesteuerung und europäisches Gemeinschaftsrecht,* DER BETRIEB (2002). ECJ decision: Cadbury / Schweppes C-196/04, 18.11.2006.

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credit in Germany for withholding taxes referred to tax exempt income. However, this limitation was dropped in the final version of the act in order to be consistent with the full credit for German withholding tax levied on domestic dividends even though these too are only taxable as to one half in the hands of individual shareholders. All in all, the introduction of the partial exemption method has significantly improved net income after taxation for German individuals from their foreign investments, since only one half of the dividends is subject to taxation under current law.

Dividends received from abroad by a German resident company are exempt from German corporate income tax independently of any double tax treaty. This 95% exemption of dividends applies regardless of the level of the holding, the period for which the investment was held, or of the activity of the foreign business. Activity clauses (in the meaning of the existence of an effective commercial activity put in place by the participated company)[264] in German double tax treaty lose their relevance in respect of foreign dividends received, although activity is still important in connection with the taxation of deemed income under the CFC rule (see infra).

Dividends received by a foreign company through a German permanent establishment from a domestic or a foreign company will also be 95% exempt from German corporate income tax. This 95% exemption under Section 8b, subsection 1, dKStG also applies to dividends on shares indirectly held through a partnership apportioning its income by source among the partners.

It has to be remembered that an amount equal to 5 % of the dividend received from abroad by a German resident company remains tax non-deductible according to Section 8b (5) KSTG. This provision applies regardless of a double tax treaty. Effectively, it means that only 95 % of a foreign source dividend is tax exempt, whilst all specific expenses incurred in connection with financing or

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[264] Marco Moscariello and Moscaroli Roberta, *La commercialità nel regime della participation exemption - rilievi critici sui recenti orientamenti restrittivi*, 13 BOLLETTINO TRIBUTARIO D'INFORMAZIONI 1018, 1023 (2010); Ilario Scafati, *Il requisito della commercialità nella "participation exemption,"* 10 Corriere tributario 780, 785 (2007).

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maintaining the foreign investment are tax deductible. The same rule applies for resident companies.

For individuals as dividend recipients, the deductibility of expenses linked to Partially exempt dividend income from abroad or from German companies is limited to 40 per cent of its amount and only if those expenses are linked to the received dividends in an economic sense.

Profits distributed by a foreign company are exempt to the same extent as profits distributed by a resident company if the type comparison results that the foreign company is similar to a domestic company. The German legislator assumes that income realized by foreign companies had already been subject to tax. Once again, in cases of foreign tax rates applicable to the non-resident subsidiary, an additional taxation can apply if the controlled foreign subsidiary is taxed less than a similar subsidiary resident in Germany.

Total exclusion for dividends received within a fiscal unit

As mentioned above, the taxes on dividends can be reduced in cases of fiscal unities according to the rules about consolidation for tax purposes. It appears useful to briefly indicate the German rules for consolidation under tax provisions.
A tax group can always consist of one Parent Company or parent partnership (Organtraeger) and at least one subsidiary company (Organgesellschaft). The prerequisites to establish a tax consolidation differ for the various taxes (corporate income and trade tax vs value-added tax).

In order to achieve tax consolidation for corporate and trade tax purposes, the so-called financial integration and a profit-and-loss transfer agreement are required.

The parent company or parent partnership must directly or indirectly hold the majority of voting rights ("Controlling Parent Company") in the subsidiary ("Controlled Subsidiary Company") from the beginning of the latter's business year. An indirect share is sufficient only if each indirect interest itself grants a majority of voting rights.

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A profit-and-loss transfer agreement (so-called Ergebnisabführungsvertrag) must be concluded between the Controlled Subsidiary Company and the Controlling Parent Company. Under this agreement, the Controlled Subsidiary Company is obliged to transfer its entire annual profit to the parent, but at the same time the Controlling Parent Company commits itself to compensate the losses of the subsidiary. The agreement must run for at least five years, and must be concluded until the end of the first year in which it shall take effect. The tax consequences will apply not before the year in which the agreement is registered with the Commercial Register of the Controlling Parent Company and the Controlled Subsidiary Company. The agreement must be notarized by a public notary.

If the profit-and-loss transfer agreement is not effectively carried out in any of the first five years (i.e. the subsidiaries fail to surrender their entire profit, or the parent defaults on its obligation to take over the losses), the agreement is for tax purposes only retroactively treated as if it had never been concluded and the Controlling Parent Company and the Controlled Subsidiary Company involved are reassessed for tax purposes. As a result, the profits previously surrendered or the losses previously suffered would be re-qualified as deemed dividends or deemed contributions. A profit-and-loss transfer agreement, however, may be cancelled because of important reasons without adverse effect, e.g. sale of the Controlled Subsidiary Company, merger or contribution.

Profits of the Controlled Subsidiary Company will be transferred to the Controlling Parent Company due to a profit transfer agreement. Since the profits will not be taxed on the level of the respective Controlled Subsidiary Company, one level of taxation is left out. Income of the Controlled Subsidiary Company will be determined on the level of the Controlling Parent Company by adding profits and deducting expenses and tax exemptions (first step). In a second step the so determined net income of the Controlled Subsidiary Company will be added in full to the Controlling Parent Company and is subject to taxation on the level of the Controlling Parent Company ("Net Income Method"). On the other hand this Net Income Method does not apply to dividend income of the Controlled Subsidiary Company. Instead of the Net Income Method dividends will be treated as follows: In the first step, the Participation Exemption will not apply to determination of dividend income of the Controlled Subsidiary Company pursuant to Section 15, subsection 2,

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dKStG. Instead, the gross amount of dividend income (i.e. 100%) will be added to the level of the Controlling Parent Company ("Gross Income Method"). The Participation Exemption will only apply on the level of the Controlling Parent Company as if the Controlling Parent Company had received the respective dividend income on their own.

The effects on the taxation of profits received by shareholding companies went through some reforms. Now, if a Controlled Subsidiary Company with a German place of management and seat has concluded a profit transfer agreement within the meaning of the German Stock Company Act (AktG) under which it shall surrender its entire profit to Controlling Parent Company this profit will be taxed, under certain conditions, by the Controlling Parent Company rather than by the subsidiary (Section 14 and 17 dKStG). The Tax Reduction Act eased the conditions for Organschaft in two ways. First, the Controlled Subsidiary Company, under previous law, not only had to be majority owned by the parent, but there also had to be business and management integration between the two, rather as though they were business units of the same company. This business and management integration has now been dropped for corporate income tax purposes (although not for trade tax) leaving the so called financial integration (the parent holds more than 50% of the voting rights in the subsidiary) as sole criterion. The second change is, perhaps, of less general importance; under previous law the minimum shareholding level could be met either by a direct or indirect holding, but not by a combination of both. This accumulation prohibition has now been dropped.

Deductibility of costs incurred for the management of the participation

Going beyond the general non-deductibility rule with respect to 5 per cent of the distributed profit, a fiscal irrelevance of down writings is put in place in the German system. This is systematically connected with the exemption of profits and capital gains. The same treatment is granted to losses because of down writings to fair market value after the sale of participations, reduction of capital and liquidation losses. No limitation is prescribed in addition to the standard non-deductible portion as of Section 8b subsection 5. Therefore all expenses connected with the management of participations are deductible.

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2. The transplant of the participation exemption model in Italy

a. Transition from the imputation method to the participation exemption method

Following a development introduced by several European legislators, Italy came to the decision to introduce a major reform of its fiscal system in 2004, innovating the system for the taxation of dividends, skipping from an Imputation System to a Shareholder Relief or Classical System.
The relevant part of this reform, observed in this part of the work is the tax treatment of dividends deriving from participated companies.[265]

It has to be mentioned that through a correction in 2005,[266] some basic characteristics of the taxation model were changed,[267] introducing some corrections that were partially cancelled by a subsequent tax reform[268] that partially corrected the version previously in place. For this analysis it is not important what the effective qualities of the applicable rule were in the years from 2003 to today but only if there has been a substantial change concerning the applied model. The analysis will start by observing what had occurred principally in the moment of systematic change from the imputation method to the exemption method. The subsequent tax reforms only modified some details of the applicable model and while therefore having an effect in analysing the

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[265] Giancarlo Ferranti, *L'ambito oggettivo della particiption exemption*, CORR. TRIB. 1306 (2004); Sebastiano Garufi, *La tassazione dei dividendi in capo alle persone fisiche nel mercato interno*, FISCALITÀ INTERNAZIONALE 147 (2004); Raffaello Lupi, *Delega fiscale, redditi finanziari e redditi d'impresa: un'imposizione reale onerosa per i redditi elevati?* RASS. TRIB. 107 (2003); Marco Magenta, *La participation exemption relativa ai dividendi nella riforma fiscale*, FISCALITÀ INTERNAZIONALE 435 (2003); Siegfried Mayr, *Riforma Tremonti: Il nuovo regime di tassazione dei dividendi. Parte prima*, BOLL. TRIB. 1368 (2003).
[266] D. LGS. N. 247/2005.
[267] Gianfranco Ferranti, *Le partecipazioni societarie nel correttivo ires*, 18 CORRIERE TRIBUTARIO 1395 (2005); Carlo Sallustio, *La tassazione dei dividendi esteri, prima e dopo il Decreto "correttivo Ires 2005"*; Gianfranco Ferranti, *Le novita' del correttivo ires per le plusvalenze realizzate nell'attivita' d'impresa*, 48 CORRIERE TRIBUTARIO 3767 (2005); Norberto Arquilla, *Tassazione dei redditi diversi di natura finanziaria nel correttivo ires*, 48 CORRIERE TRIBUTARIO 3775 (2005).
[268] L. 24.12.2007 N. 244.

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rationale of the legislation, the pure technique of comparison will work as the presently applicable version of participation exemption was in place without modifications since the introduction of the model.

It is in this respect positive to observe that the introduction of a new system of dividend taxation has contributed to modernize the Italian tax system and abolish certain potentially discriminatory effects on internationally operating companies and shareholders: firstly, the new system corresponds in its logic to the one applicable in the majority of European neighbours' and the world's industrialized countries;[269] secondly, it eliminates most of the discrimination issues with respect to foreign companies holding shares in Italian companies. In detail such discrimination issues were raised with respect to the fact that in the former Imputation System foreign shareholders did not obtain a tax credit connected to the Corporate Income Tax borne by the Italian subsidiary or controlled company.

The reform finds its centre in Section 87 of the Italian Income Tax Act . The main objective of the 2004 tax reform is a total exemption for dividends and capital gains received by companies and a partial exemption for those received by individuals or partnerships. This is the system from now on called Participation Exemption. Worth mentioning (but for a deeper analysis, compare paragraphs about comparisons between the analysed systems), that a passage from an Imputation System to one of either partial or full shareholder relief was put in place also by other European legislators, such as Austria, Belgium, The Netherlands and Luxembourg.[270]

Dividends received by companies falling into the scope of application of Section 89 are exempt at a rate of 95%. The partial taxability will be evaluated more deeply in the paragraphs about comparison, as it has an outcome on the effective tax rate borne by Italian companies, but not on the systematic approach for dividend taxation. It will be observed by the reader, that the

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[269] Francesco Pedrotti, *La participation exemption quale nuovo regime ordinario di circolazione delle partecipazioni societarie*, 10 RIVISTA DI DIRITTO TRIBUTARIO 1137, 1163 (2005).

[270] Cirrincione and Spinoso, *Le società holding e l'istituto della cd. participation exemption vigente in Belgio, Lussemburgo, Francia e Germania*, 1 FISCALITA´INTERNAZIONALE 75, 85 (2006).

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Italian Participation Exemption does not prescribe conditions which are difficult to meet, but presents a relatively broad scope of application (for an effective comparison between the scopes of the Italian and German Participation Exemption, see infra).

Double taxation and discrimination avoidance

The previous legislation with respect to the taxation of dividends received by companies, attributed a tax credit creditable against the corporate tax borne by the participated company only to resident shareholding companies or those holding a permanent establishment in Italy, which included the respective participation in its books. The only exceptions were represented by specific double tax treaties prescribing a full creditability of the subsidiary's corporate tax with respect to distribution of dividends to a foreign parent company. Of course such a system for dividends taxation was strongly suspected to be in conflict with the principles of the EU Treaty, not in one, but in two senses: firstly, the discrimination could be seen between parent companies resident in EU countries and not holding permanent establishments in Italy versus companies resident in Italy or EU companies holding PE's in Italy; secondly, the discrimination could be seen between countries benefiting from a more favourable set of rules because of a specific double tax treaty with Germany and countries underlying the standard rule of non-creditability, stated by the Italian legislator.
The aforementioned is only one of the reasons that caused the Italian legislator to skip over to a classical system, which eliminates most of the abovementioned discrimination issues.[271]

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[271] Carlo Sallustio, *La tassazione dei dividendi esteri, prima e dopo il Decreto "correttivo Ires 2005"*, in www.tributimpresa.it; Enzo Mignarri, *Trattamento fiscale dei dividendi di fonte estera: la disciplina in vigore e le problematiche interpretative e applicative*, 37 IL FISCO 5448 (2007); Fabio Ciani, *Dividendi "esteri" all'esame della Corte di Giustizia UE e dell'Agenzia delle Entrate: risoluzione n. 80/E del 26 aprile 2007*, 30 IL FISCO 4400 (2007).

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<u>Irrelevance of fiscal residence of the shareholder for the concern of dividend taxation</u>

A simplification in the tax system occurred also when the former applicable, multiple rules with respect to the treatment of dividends were abolished: in the former system there were many different rules and, as mentioned above, a different provision with respect to dividends received by an Italian resident from abroad or from resident companies. It is clear that such a difference was in conflict with the principle of non-discrimination between resident and non-resident companies distributing profits to an Italian resident shareholder. The tax reform introduced a substantially identical treatment for profits distributed by resident and non-resident companies to an Italian resident shareholder with the exception of a specific anti-tax haven rule, referred to profits distributed by companies resident in countries included in Section 110, TUIR.[272]

Some doubts remainregarding the compatibility of the Italian withholding taxation rules with respect to non-resident companies and EU law: while resident shareholders bear a withholding tax equal to 12,5 % in the case of distributions between companies and individuals and equal to zero in case of distributions between companies, shareholders resident in other EU countries bear a withholding taxation equal to 27 % with the exception represented by the cases of applicability of the EU Parent Subsidiary Directive, under which no withholding tax is applied. These doubts cannot be confirmed, as the PSD itself lists the cases of non-applicability for withholding taxation in a detailed way and does not forbid to apply withholding taxation in other cases. This is why this circumstance does not lead to any discrimination issues.[273]

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[272] Gilberto Gelosa, *Le acquisizioni societarie. I profili fiscali - Taxation of companies' acquisitions*, 14 IL NUOVO DIRITTO DELLE SOCIETÀ 9, 90 (2011); Carlo Garbarino, *Participation exemption e operazioni straordinarie*, 5 TRIBUTIMPRESA 47, 69 (2005); Luca Rossi and Paolo Scarioni, *La participation exemption nelle operazioni straordinarie*, 18 BOLLETTINO TRIBUTARIO D'INFORMAZIONI 1349, 1358 (2005).

[273] See also COM (2003), Dividend taxation of individuals in the internal market 19/12/2003.

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b. Analysis of the scope of exemption

First of all, it must be said that the relevant profit under this circumstance is the one distributed under any title. It is not important in theory, if the profit arises from an open dividend distribution or in other possible hidden ways. This is openly stated by the Italian Income tax Act in Section 89, subsection 2. The clear identification of the personal scope of application with regards to legal persons occurs by means of Section 73, subsection 1, letters a and b, which states that profits are not included in taxable income, but exempt for 95% of their amount, if they are caused by participations (or payments at the end of a shareholdership, reductions of capital, etc.)[274] in the following companies:
Shares in Companies of every kind, including those in limitedly liable partnerships organized in shares; Shares in LLC's; Participations in cooperatives; Participations in other companies having the rights of a company; Participations in companies different from companies, resident in Italy, carrying on prevalently business activity; Participations in public or private companies, different from companies; Participations in mutual insurance companies resident in Italy.

With respect to participations in companies organized as individuals, the applicable rule is stated by Section 5 TUIR, a rule stating favourable prescriptions for family businesses as well as giving rules for the determination of the relevant participation in those companies.

A different rule is stated for companies resident in tax havens.

c. Different sets of rules with regard to the nature of the shareholder

Under the concept of a shareholder relief system, dividends and other distributions on shares held in a company are wholly or partially exempted from further taxation in the hands of shareholders. Supposing further applicability conditions are met, the Italian Income Tax Act includes several categories benefiting from the recently introduced shareholder relief system. Tax law

[274] See Section 47, subSection 7 ITA.

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therefore differentiates between shareholders being individuals, such as individuals and partnerships, and corporate bodies, such as for instance companies and associations. Also, there is a difference in Italian tax law with respect to individuals as shareholders who received profits by either business activity or outside business activity (investments). An additional difference exists between the legal treatment of dividends if they derive from qualified participations or participations not being definable as such. Dividends caused by participation in Italian resident companies present a different legal treatment than those arising because of shareholding in non-resident companies. Non-resident corporate shareholders must install an Italian permanent establishment and the relevant participations must be booked in this permanent establishment for tax purposes. The participation must be effectively linked to the Italian permanent establishment under functional aspects.

Section 89, subsection 2 TUIR states that profits distributed by persons subject to the Corporate Income Tax as of Section 73, subsection 1, Letters a) and b) are excluded from the tax base for 95 % of their amount without the necessity of further conditions to be met by the distributing company or the receiving person as in other applications of the Participation Exemption model, such as minimum participations, holding periods, the booking in the shareholder’s accounts of the participation, the effective taxation of the distributing company, with exception of companies resident in tax havens, the legal title of the participation’s possession, the inclusion of the distributing company in a white list of countries.

Worth noting is the strong difference with respect to the rules regarding the exemption of capital gains, which prescribe a series of conditions to be met by both distributing and receiving person.

The tax reform of 2003 had the well accepted effect of reducing the confusing number of different rules with respect to dividends received by companies not resident in Italy. In fact the previous system applied different treatments with reference to the residence of the company the shares were held in and the percentage of participation. In case of participation for a percentage of more than 25 % in the communitarian company’s capital, the received dividend was exempt for 95 % of its amount according to Section 96-bis, subsection 1,2 and 2bis TUIR. The same treatment was granted to the corresponding companies,

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resident in white list countries different from EU countries according to Section 96-bis, subsection 2-ter ITA. In case of lower percentages of participation in the company's capital and a place of residence of the company different from black list countries, the received dividend resulted taxable for 60 % of its amount according to Section 96, subsection 1 ITA. In case of shareholdings in companies resident in black list countries, and without usage of the so-called transparency taxation, a full taxability of the received amount referred to the difference between the full dividend and the expenses eventually declared not deductible in Section 76, subsection 7-bis (obligation to use fair market values in operations with controlled parties resident in black list countries). If the so-called transparency taxation as of Section 127-bis ITA was applied, only the exceeding amount was fully taxable. It is quite understandable that this set of rules is quite complex, as often criticized by the economic operators. The new system presents the same rule for all participations, whether resident or not, except those held in black list countries: exemption from 95% of their amount.

As mentioned above, the rule for the taxation of domestic dividends distributed to companies subject to the Italian Corporate Income Tax was regulated under the logic of an Imputation System: the shareholder obtained a dividend netted by the corporate income tax borne by the distributing company contemporary to a tax credit to be used in its tax return which could be, depending on the distributing company's baskets, either full or limited (see supra).

Definition

From an economic point of view, a profit distribution can be defined as remuneration of those persons who, in their position as shareholders, made an investment in the capital of an enterprise organized as a company. Such a remuneration is exclusively linked to the economic result of the enterprise, differently from remunerations prescribed by financiering contracts between the company and other persons. From a juridical point of view, a dividend is the part of the company's profit distributed to the shareholders in proportion to their participation in the company's capital. In the Italian legal system profits

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can only be distributed if they are realized.[275] This fact is relevant for tax purposes, as well, if one considers that an inexistent profit distributed to the shareholder determines a reduction of the company's capital and not a distribution of the surplus realizes by the company in the moment of distribution. This is why a profit distribution can only be referred to financial data as a starting point, otherwise it can only be defined as reduction of capital and therefore a reimbursement of the company's capital that does not increase the shareholder' s ability to pay taxes. The requirement is transposed in the Income Tax Act in Section 49, 59 and 81 where the phrase distribution under any title and with any denomination is stated. It is known that profit distributions can happen in various ways and with several different titles. The same principle is stated by Section 27 of the Decree by the President, N. 600 of 1973, that imposes to apply a withholding tax on all kinds of profits distributed. This rule is potentially in conflict with the principles of the EC – Treaty.[276] The distribution of profits can be put in place for cash or for goods. If goods are given to the shareholder, they have to be valued with the help of the fair market value according to Section 47 and 109 ITA. It has to be remembered that the relevant date for the realization of profits is the public act with respect to companies and immovable property and the moment of shipping or handing out for movable goods.

As stated above payments from the capital of the company do not constitute profits in the definition of Section 47 ITA, but just reduce the fiscal value of the participation. The amounts received by the shareholder in cases of capital reimbursements, liquidation or interruption of shareholdership do constitute profits for the amount resulting from the difference between the obtained compensation and the former payment in the company's capital; these aforementioned payments are considered capital gains according to Section 87, subsection 5 bis.

As Section 47, subsection 5 allows a company to book certain profits as reserves in tax suspension, the Italian legislator decided to include also a

[275] See Section 2433 Civil Code.
[276] Sebastiano Garufi, *La tassazione dei dividendi in capo alle persone fisiche nel mercato interno*, FISCALITÀ INTERNAZIONALE 147 (2004).

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regulation with respect to the order between profits resulting from different funds in the company's capital: now there is an absolute legislative presumption[277] stating that the reserve in tax suspension is the one distributed after all other taxable funds, see Section 47, subsection 1. This is valid also for distributions paid by non-resident companies. In case of a distribution those non-taxable reserves have to be marked, as the civil code does not present a difference in the distribution of those two types of funds. In case of legal distributions of booked in the tax suspension reserve, there will be a reduction of the participations' fair market value and a non-taxability with respect to the receiving shareholder.

The heart of the new system for the taxation of dividends received by legal persons is Section 89, subsection 2 ITA that sets the rule that income in the sense of Section 73, subsection 1, lit a) and b) ITA is exempt for 95 % of its amount. The rule itself is peculiar with reference to other European applications of the tax model Participation Exemption, as it does not apply such an exemption to minimum holding periods, minimum participations in the capital of the company the shares are held in, minimum taxation of the participated company, legal title of the participation's possession or inclusion of the country of the participated company's country of residence among a white list. The same treatment is granted to a participant in a membership company, to participations as of Section 2554 Civil Code different from those in which the shareholder contributes to the company's capital with its manpower (participations not based on a cash payment in the company's capital) and interest paid to shareholders exceeding the amount allowed by Section 98 ITA (thin capitalization provision). A first view across the border leads to the conclusion that Italy does not present a provision that includes all payments to the shareholder, both open and hidden, but only open payments and some clearly identified hidden contributions, such as the one included in Section 98 ITA.

For the case of a link between Participation Exemption provision and thin capitalization provision, the rule of Section 89, subsection 2, lit a) and b) clearly states that is not relevant at which stage the taxpayer realizes they have gone

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[277] Carlo Garbarino, *Persone fisiche residenti, il nuovo regime dei dividendi di fonte estera*, FISCALITÀ INTERNAZIONALE 215 (2004).

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beyond the limits of Section 98. The exceeding amounts received by this last person will always be considered dividends, whether directly declared in the tax return or later adjusted through a tax audit.

A generic title is considered a share for tax purposes if its remuneration consists totally in a profit participation of the company the shares are hold in, in other companies being part of the same economic group and referred to the specific business the shares were emitted for.[278] Worth noting is the circumstance that the Italian legislator chose a more restricted scope of application for the classification of similarity as he had done in other circumstances, as for example in non-deductibility provisions, included in Section 109, subsection 9, lit a).
The fact is that a payment between shareholder and company must be related to the company's profits in a full way, while for non-deductibility issues a partial correlation is sufficient. The link to the respective definition is made for cases of foreign dividend payers: the payment will be considered a dividend by the Italian tax administration only if the shareholder presents clear documentation proving that the respective payment is non-deductible in the country the controlled company is resident in.

The Italian tax system has always recognized that there is a difference between the taxation of profits and capital gains arisen because of business and those from investment activity. Unlike in other EU countries this incentive was not limited to a certain capital or a certain amount of income connected with the same capital, but flat. This fact is not well known, but Italy is still an excellent place for private investors realizing high income through capital gains. The average taxation in Italy is one half of the high tax countries in the EU, such as Germany. Coherent to this, in the former system differentiations for the taxation of individuals were existent with reference to the residence of the controlled company and the percentage of participation in the company's

[278] See Section 44, subsection 2, lit a).

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capital. A so-called non-qualified shareholder[279] receiving profits from an Italian resident company had to bear only a flat tax of 12,5%. There also was an option of regular taxation following the Imputation System for profits from non-qualified participations, if chosen by the taxpayer. This was convenient in certain personal conditions. Profits arising from higher participation were taxed according the usual Imputation System with the attribution of a tax credit for the shareholder. Distributions put in place by foreign companies were subject to a border taxation, a withholding tax applied by the financial intermediaries engaged in the management of the payments. No flat tax or tax credit were granted to the shareholder.

It is easily understandable that the treatment of those two types of dividends was clearly less favourable for those having their origin abroad. The ECJ ruled[280] that such a set of rules is discriminating foreign companies as the Italian flat tax system, which has the significance of a consistent reduction of the effective tax rate, is granted only with reference to resident companies. This was, as mentioned at the beginning of this chapter, only one of the reasons why the Italian legislator decided to equalize the tax treatment of dividends received by resident individuals from non-resident companies and those profits received by the same persons from companies resident in EU countries.

This aim was successful, as nowadays the system of dividend taxation does not present exceptions or rules of minor favour, related to the paying company's country of residence. The only exception to this general rule is a distinct set of rules with respect to companies resident in tax havens. This leads to an actual situation where profits distributed by foreign companies bear a flat tax of 12,5 % in case of non-qualified participations and in case of qualified participations an amount to the same extent is levied under the title of a prepayment, which is then cleared against the final income tax. Another innovation of major importance is that since 2004 the withholding tax borne in the distributing

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[279] Holding less than 20 percent of the voting rights or less than 25 percent of the rights to participate in the company's profit. In case of companies listed in the stock market, those amounts were respectively 2 and 5 percent.
[280] C – 35/98 of July 6th, 2000; C – 516/99 of May 30th, 2002.

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company’s country of residence has been fully creditable in the shareholder’s Italian tax return.

The transition from Imputation System to classical system of course has an effect on the taxation of individuals holding qualified participations. The taxation in this respect occurs at the full effective rate of the shareholder, but limitedly on the basis of 49,72% of the received profit.

It was explained that the profits arisen because of qualified participations cause a taxation at the full tax rate referred to 49,72% of the gross amount received. With reference participations in foreign companies, different from those resident in tax havens, it has to be stated that the Italian tax system presents an entry taxation resulting in a withholding tax equal to 12,5 % of the net frontier amount, which is the amount of the foreign dividend minus the foreign withholding tax. The net amount resulting from this operation is either already taxed in a definitive way in the case of non-qualified participations or to be filed with the Italian tax return in case of qualified participations: now the gross amount of the foreign profit (i.e. the gross amount of both foreign and Italian withholding tax) is required to be indicated, deductible amounts are represented by the Italian entry or border taxation and the foreign withholding tax, both of course with reference to 40 % of their amount consistently to the aforementioned.

The reduction to 49,72% of the received dividend amount referred to the inclusion in the tax base, as stated by Section 47 ITA, is also applicable to individuals carrying on business activity and receiving the dividend payment as a consequence of that activity. The legislative technique applied is a link of Section 59, which refers to the taxation of partnerships and individuals for their business activity, to Section 47. Flat tax rates are not made applicable to this kind of income.

Total exclusion for dividends received within a fiscal unit

The treatment of profits distributed in groups having presented an option for fiscal consolidation according to Section 122 ff. is ruled by Section 122, subsection 1, lit a) and Section 134, subsection 1, lit a) ITA. The provisions state that income received by the consolidating holding by its consolidated

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subsidiaries is totally exempt, going even further than the regular exemption equal to 95 % of the received profit. This is certainly effective from the point of view of the purpose of a set of rules applying to consolidation for tax purposes. Technically, the total exemption of the taxable portion of profits distributed is caused by a consolidation correction on the level of the controlling consolidating company, granting this rule of favour only to the last holding company of each group of consolidated companies.

Deductibility of costs incurred for the management of the participation

As stated above, some European legislators connected the introduction of a Participation Exemption provision with the application of a general disallowance provision with respect to expenses linked to the participations relevant for the purposes of the exemption provision itself. Moreover, such behaviour is granted to European legislators by PDS 90/435/CEE, which introduces the possibility of non-deductibility provisions connected to exempt profit distributed between subsidiaries and parent companies. The rule continues stating that, if the deduction of expenses linked to exempt participations is granted only for a fixed portion, that portion cannot exceed 5 % of the relevant profit. That rule was included in the Italian legislation by Section 96-bis ITA that states that the respective profits are taxable for 5 % of their amount and the deductibility of the relevant connected expenses is accordingly possible without any limit. This approach has been kept also under the premises of the introduction of the participation provision. In fact Section 109 ITA states that expenses linked to exempt participations, as of Section 87 ITA, are fully deductible under the condition that the profit is taxed for 5% of its amount. Of course this rule is not favourable if there are no expenses borne with respect to the participation, as the profit is taxable for 5 % of its amount nonetheless.

It is remarkable that, despite long lasting criticism from the academic world, the Italian legislator kept the models nearly unaltered for almost 10 years.[281]

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[281] Roberto Lugano and Marco Nessi, *Le principali novità nella determinazione del reddito d'impresa introdotte dalla legge finanziaria* 2008, 3 RIVISTA DEI DOTTORI COMMERCIALISTI 611, 625 (2008); Gianluca Dan, *Finanziaria 2008: guida alle principali novità per le societá,* 3 LE SOCIETÀ 351, 359 (2008); *La riforma "parziale" della pex*. 42 CORRIERE TRIBUTARIO

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3. The peculiar aspect of the Austrian solution: partial participation exemption

Austria, as other European countries, adopts a classical dividend taxation system, sustained by participation exemption. According to Section 10, subsection 1 öKStG distributions are exempt from corporate income tax in the hands of the recipient company, regardless of the size of the holding.

This last aspect concerning the requirements to be met by the specific participation is relevant as the Austrian tax system had been heavily criticized because of the circumstance that it formerly set forth that income from participations in third countries (international participation exemption) was deemed not taxable only under additional conditions such as a minimum participation held by the Austrian shareholder.[282]

The same rules applying for open profit distributions apply also for hidden distributions according to Section 23 and 12 of the öEStG and öKStG respectively. Costs related to such shareholdings are not deductible.

Participation exemption does not extend to capital gains and liquidation proceeds.

3391, 3394 (2008); 24. Gianfranco Ferranti, *Le proposte della Commissione Biasco per la riforma della "pex",* 33 CORRIERE TRIBUTARIO 2647, 2653 (2007); Loredana Carpentieri, *Le prospettive evolutive dell'Ires: la participation exemption* 4 RIVISTA DI DIRITTO TRIBUTARIO 371, 378 (2007); Tommaso Di Tanno, *Linee guida per una possibile riforma dell'imposizione sul reddito d'impresa*, 1 DIRITTO E PRATICA TRIBUTARIA 81, 96 (2007); Giampaolo Arachi and Tommaso Di Tanno and Gianfranco Ferranti and Raffaello Lupi and Stevanato Dario, *Quali riforme per la participation exemption?* 10 DIALOGHI DI DIRITTO TRIBUTARIO 1217 – 1266 (2006); Roberto Lugano, *Il nuovo volto della participation exemption dopo le modifiche introdotte dal d.l. n. 203/2005,* 6 RIVISTA DEI DOTTORI COMMERCIALISTI 1195 – 1202 (2005).

[282] Georg Kofler, *Austria: Supreme Administrative Court rules on the EC-compatibility of the international participation exemption*, 6 EC TAX REVIEW 293 (2008); Georg Kofler, *Austria: requests for preliminary rulings concerning the EC-incompatibility of the Austrian international participation exemption Regime: C-436/08 Haribo, C-437/08 Österreichische Salinen*, 1 EC Tax Review 57 (2009).

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The exemption applies also to private foundations receiving dividends from resident companies.[283]

a. Different kinds of participation exemption

The name itself of the Austrian tax system for dividends received by corporate shareholder, gives quite a clear view on the rationale of the Austrian choice. Schachtelprivileg, this is the legal term used, means privilege for corporate participations. The term privilege is quite coherent with a system that had many discrepancies, especially concerning non Austrian participations.

According to the Austrian system, any income derived from the holding of a participation realized by a resident company is exempt from corporate income tax.
There are no minimum requirements concerning minimum participations or minimum holding periods or conditions with reference to the inclusion among certain booking categories of the participation itself.

No further conditions apply to this tax exemption. The participation exemption does not extend to capital gains and liquidation proceeds.[284]

Differing from those of domestic participations, the benefits from international participation exemption referred to corporate shareholding apply only under more strict conditions, such as minimum participation with reference to the percentage of shares held or percentage of voting rights exercisable, holding period, effective taxation of the distributing party, cooperation in tax matters with the country of residence of the payer.
Those rules are no longer applicable due to legislative change occurred 2009 after heavy criticism. [285]

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[283] YVONNE SCHUCHTER AND FRIEDRICH SCHNEIDER, AUSTRIA - CORPORATE TAXATION SEC. 2, COUNTRY SURVEYS IBFD.
[284] See infra CHAPTER IV, Austria.
[285] *GEORG KOFLER*, Austria: Supreme Administrative Court rules on the EC-compatibility, supra note 305; *GEORG KOFLER*, Austria: requests for preliminary rulings, supra note 305, at 309.

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A particular rule concerns permanent establishment of EU resident parent companies: if a permanent establishment of a EU resident parent company receives a dividend payment by an Austrian subsidiary, this payment is treated as an Austrian dividend for tax purposes.[286]

Withholding tax is not due on dividends paid to a resident company that holds at least 25% of the shares in the distributing company[287] As from April 2012, the minimum participation requirement is reduced to 10%. The legislator decided to include also indirect holdings in the scope of application of the participation requirement.
Non-resident companies have to bear a final withholding tax if they do not apply for the EU parent subsidiary directive. Companies resident in the European Economic Area apply for the same treatment as the companies falling within the scope of application of the parent-subsidiary-directive under the additional conditions that the distributing entity is taxed for the distributed profit, that the profit distribution is not tax deductible and that the corporate tax referred to the distributing or receiving entity is not below 15 per cent.

The Austrian legislator extended the sphere of application of participation to portfolio dividends by means of the Tax Amendment Law 2009 which stated that participation exemption was applicable to portfolio dividends, i.e. participations of less than 10% derived from companies resident in EEA Member States.

After that, Austria again broadened the scope of application of the international participation exemption: following a relevant ECJ decision[288] on 10th February 2011, the Tax Amendment Act 2011 extended the participation exemption to portfolio dividends derived from companies resident in third countries, on the condition that there had been an agreement on mutual assistance with the company's state of residence and Austria.

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[286] Section 21, subsection 1, number 2, letter a) öKStG.
[287] Sec. 94 öEStG.
[288] joint cases of Haribo Lakritzen Hans Riegel v. Finanzamt Linz (C-436/08) and Österreichische Salinen AG v. Finanzamt Linz (C-437/08).

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b. Structure of the exclusion

Withholding tax applies to Dividends and other profit distributions by resident companies to resident corporate shareholders that do not hold at least 10% (directly or indirectly) of the shares in the distributing company.

What appears to be incoherent under systematic aspects was confirmed during the last tax reform: even though the relevant dividends are usually deemed to be exempt, a credit is allowed for the relevant withholding tax imposed income tax. If the credit exceeds the recipient company's corporate income tax liability, the excess is refunded. Distributions to non-resident companies are subject to a final withholding tax.

The list of companies benefitting from the participation exemption regime is very long and comprehensive: almost every kind of participation in companies is included[289] and almost any type of corporate shareholder is within the scope of application of this provision.
This is also applicable to countries belonging to the European Economic Community.[290]

Resident persons subject to personal income tax

Certain income, such as distributions from resident companies to individual shareholders, is taxable with a flat tax rate equal to 25% per cent (Kapitalertragssteuer, Tax on Capital Income). This tax is designed as a withholding tax directly retained by the distributing company and transferred to the tax administration.[291] In alternative the partial income system applies.[292]

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[289] GEROLD STOLL, WOLFGANG GASSNER, MICHAEL LANG, JOSEPH SCHUCH, KLAUS STARINGER (EDS.), SCHRIFTEN UND AKTUELLE BEITRÄGE ZUM ÖSTERREICHISCHEN ABGABENRECHT 424 (2008).
[290] HANS *HASSLINGER in GEROLD STOLL, WOLFGANG GASSNER, MICHAEL LANG, JOSEPH SCHUCH, KLAUS STARINGER (EDS.)*, supra note 312, at 435.
[291] WERNER DORALT, STEUERRECHT (2010), GERHARD MANZ, STEUERRECHT (2010).

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Dividends are completely excluded from the tax base, according to Section 10, subsection. 1 CITA-AU and this rule is, as stated above, extended to non-resident shareholders being corporations.

Deductibility of costs incurred for the management of the participation

As a consequence of the exemption of profits, the connected expenses bear a special treatment, different from that referred to ordinary costs: interest, for example, is not deductible if it arises to generate tax-free income.

A particular opportunity for tax planning is the rule that loans contracted by resident companies in order to buy participations in foreign corporations, when referred to their business assets, are tax deductible even if the dividends received from such participation are tax-exempt in the hands of the recipient company.[293]

This rule changed in January 2011, when the 2011 tax reform introduced a rule, Section 10, subsection 3, which states that interest on loans contracted in order to buy intergroup participations is no longer deductible.   taken out to finance the acquisition of intercompany participation is not deductible.

Concerning the treatment of individual shareholders holding their participations as portfolio investments, there has been introduction of a complete new taxation of income from capital investment.
The formerly applicable full participation exemption regime as well provided for with reference to capital gains from the sale of shares is no longer applicable.

Any capital gains resulting from the sale of shares or stock will be taxed at a flat rate of 25%. The same is valid for basically any income resulting from capital investment, be it dividends, interest or capital gains, irrespective of

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[292] MARTIN VOCK, KÖRPERSCHAFTSSTEUER (2011) in PETER QUANTSCHNIGG AND BERNHARD RENNER AND GOTTFRIED SCHELLMANN AND REINHARD (EDS), KOMMENTAR ZUM KSTG.
[293] PETER DORALT, DIE BESTEUERUNG DER KAPITALGESELLSCHAFT (1986).

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whether itderives from portfolio or substantial participations, derivatives or other financial instruments, loans or funds deposited on bank accounts. These rules shall apply equally to instruments held privately or as a business asset.

4. The simplified adoption of the "participation exemption model" in Switzerland

a. Introduction

Under the Swiss system of participation relief, dividends are generally taxable for the recipient company but income arising from substantial participations in resident or non-resident companies is granted. This present form of participation exemption leads to the inclusion of the received dividend into the taxable income but, under the condition that the shareholding is deemed to be substantial and therefore qualifying for the model, the corporate income tax on total net income (gross amount considered including the dividends) is reduced by a fraction equal to the proportion between net dividend and total net income.

The calculation of the net dividend is put in place as follows: gross dividend income from the substantial participation, less related financing costs (e.g. interest) and non-refundable foreign withholding taxes. Moreover, a lump sum of 5% of the gross dividend is deducted to take account of personal and management costs. There is the possibility to prove that the effective cost was lower; if this is the case, the taxpayer may be allowed to deduct the lower amount.

Switzerland is, considering the long run, in a moment of substantial reform of its taxation. International pressure and the demands by the internal groups of interest made the Federal Tax Administration develop a series of documents which, implemented step by step through referenda, deeply modified the tax

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system with reference to the taxation of corporate groups both domestic and international.[294]

Before applying the tax reform of 2009, Switzerland did not apply a system very comparable to the Participation Model, already used in other European Countries. The first step had been to exempt dividends in participations equal to at least 20% of the equity of the company or cooperative or for participation representing a market value of at least CHF 2 million.

In fact, the Corporate Tax Reform of 1997 had developed this mechanism by covering also capital gains, under the condition that the gain resulting from a sale price higher than the purchase price was connected with a participation corresponding to at least 20% of the share capital of the subsidiary. The compulsory holding period was equal to one year.

To become more attractive for investments and to follow the European trend, Switzerland decided to lower the minimum participation threshold to 10% of the share capital and the minimum participation to 10%. The minimum value of the participation at fair value was consequently reduced to CHF 1 million. These easier rules were introduced by the tax reform of 2009.

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[294] TERENZIO ANGELLINI AND LARS FELD AND HEINZ HAUSER, EIN NEUES STEUERRECHT FÜR DIE SCHWEIZ: ÖKONOMISCHE GRUNDLAGEN UND GRUNDZÜGE DER RECHTLICHEN AUSGESTALTUNG, UNIVERSITÄT ST. GALLEN; GEBHARD KIRCHGÄSSNER AND ROBERT WALDBURGER, EIN NEUES STEUERRECHT FÜR DIE SCHWEIZ: ÖKONOMISCHE GRUNDLAGEN UND GRUNDZÜGE DER RECHTLICHEN AUSGESTALTUNG. GUTACHTEN ZUHANDEN DER SCHWEIZERISCHEN VEREINIGUNG FÜR STEUERRECHT (2000); ECOPLAN: ZUKUNFTS- UND WACHSTUMSORIENTIERTES STEUERSYSTEM (ZUWACHS). ANALYSE DER EFFIZIENZ-, VERTEILUNGS- UND WACHSTUMSWIRKUNGEN EINER REFORM DER INDIREKTEN STEUERN IN DER SCHWEIZ MIT DEM BERECHENBAREN ALLGEMEINEN GLEICHGEWICHTSMODELL (2006); EEAG EUROPEAN ECONOMIC ADVISORY GROUP at CESifo: THE EEAG REPORT ON THE EUROPEAN ECONOMY (2007); CHRISTIAN KEUSCHNIGG, EINE STEUERREFORM FÜR MEHR WACHSTUM IN DER SCHWEIZ (2004); CHRISTIAN KEUSCHNIGG, EIN ZUKUNFTS- UND WACHSTUMSORIENTIERTES STEUERSYSTEM FÜR DIE SCHWEIZ. ANALYSE DER EFFIZIENZ-, VERTEILUNGS- UND WACHSTUMSWIRKUNGEN (2006); MARTIN DAEPP, WELCHE LANGFRISTIGEN STEUERREFORMEN FÜR DIE SCHWEIZ? SCHLUSSBERICHT ZU DEN ERGEBNISSEN DES PROJEKTES ZUWACHS (2007).

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What is important is that the new threshold applies to both capital gains and dividends.
The qualifying holding period for capital gains remains one year. If the portion of share falls below 10% after reductions, the exemption for future capital gains will still be granted if the fair market value of the participation remains at least CHF 1 million.

b. Structure of the exclusion

The following analysis is again concentrated on the level of the federal direct tax as it is applicable to all cantons by constitution and as the single cantonal tax systems follow the rules the federal direct is based on by means of the Tax Harmonization Law (THL) which was introduced in 1990 by the Federal Parliament. The law entered into force on 1st January 1993 with the obligation for cantons and municipalities to bring their legislation in line with the law by 1 January 2001.

The THL is designed as a set of general guidelines containing provisions on tax liability, taxable income, deductions, taxable periods and assessment procedures. The cantons remain free to set their tax rates.[295]

The result in this respect is that all cantons treat dividend income from a substantial participation similarly to the federal procedure.

Sphere of application

Dividends are generally taxable on the level of the shareholder.[296] According to the participation exemption model, relief is granted with reference to substantial participation in resident or non-resident companies. Net dividends are defined as the amount of dividends received, less 5 per cent of the dividend

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[295] SIEGFRIED VAN KOMMER, SWITZERLAND - CANTONAL AND MUNICIPAL TAXATION - CORPORATE TAXATION, COUNTRY SURVEYS IBFD.
[296] Section 69, DBG.

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amount, representing deemed management costs unless effective costs can be proven and proportionate financing costs.[297]

The definition of *substantial participation* provided for by Section 70, subsection 4, letter b) DBG states that the purely numeric conditions to be met are: the ownership of at least 10% (20% before 1st January 2011) or capital stake in the dividend-paying company, or the value of the participation equal to CHF 1 million (CHF 2 million before 1st January 2011). Most of the relevant cantons follow the same thresholds indicated on the federal level. The two conditions are alternatives but the first one must be met for at least one day, meaning that the 1 million minimum value of the participation is a way to apply the exemption only if the percentage in voting rights was formerly higher than 10.

Participated companies

The participation relief applies to income from almost any type of entity having legal personality, such as income from shares in stock companies (Aktiengesellschaft) and stock companies with unlimited partners (Kommanditgesellschaft auf Aktien), participations in limited liability companies (Gesellschaft mit beschränkter Haftung), contributions in cooperatives and profit sharing certificates (Partizipationsscheine).

Similarly to what has been exposed for the Swiss model of interest deductibility limitations, the actual Swiss mode,l leading to the effect similar to that of participation exemption, has put a completely different mechanism in place: income from a substantial participation is not simply exempt but on the contrary, under the DBG the exemption is put in place by means of a participation relief (Beteiligungsabzug), which is a reduction of federal corporate income tax (CIT) by reference to the ratio between the net profits of the participations and the total net profits of the entity. The approach is, so to speak, indirect but conveys a series of qualities referable to a certain underlying rationale.[298]

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[297] See infra CHAPTER II, Switzerland.
[298] See infra, final CHAPTER IV, Comparative aspects.

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As only net dividend income is taken into consideration for the calculation of the relevant ratio of income not being added to the taxable profits, costs relating to the holding of the participation, as well as non-refundable foreign withholding taxes, are not tax deductible.

Distribution of profits under any title are considered dividends paid to corporate shareholders and as such subject to withholding tax[299] A resident corporate shareholder may obtain a refund for the tax withheld. For a non-resident shareholder the withholding tax is final unless a tax treaty provides for a refund. Before the dividend distribution takes place the Corporate shareholder may apply for the reporting procedure in order to avoid the levy of the withholding tax.

Shareholders

Switzerland has a very tolerant attitude towards off-shore corporate structure and consequent income of Swiss companies. There are no CFC rules. The relevant income is therefore tax exempt in Switzerland.[300] It seems that the tax administration is currently in the process of publishing some stricter rules on the treatment of such participations.[301]

Special conditions are made available to venture capital companies, where the qualifications to be met for the profit relief are a participation in equity equal to 5 per cent and a minimum value of the participation equal to CHF 250,000, respectively (article 4 RKGG).

To sum up, we state that the treatment of dividends is as follows:

- Corporate shareholders: full exemption if the participation counts for at least 10 per cent of the equity (Section 69, DBG);

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[299] Sec. 4 VStG and Sec. 20 VStV.
[300] Pierre Oliver Gehriger, *Holding- und Finanzgesellschaften als Instrument der internationalen Steuerplanung*, 71ARCHIV FÜR SCHWEIZERISCHES ABGABERECHT 433, 485 (2003).
[301] PIERRE OLIVER GEHRIGER AND NILS OLAF HARBEKE AND MICHAEL BEUSCH (EDS.), ENTWICKLUNGEN IM STEUERRECHT 2009, SCHULTHESS (2009).

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- Corporate shareholders: full exemption if the value of the participation is at least SFR 1 million (Section 69, DBG);
- Natural persons holding the participation among business assets: exemption equal to 50 per cent if the participation counts for at least 10 per cent of the relevant equity (Section 18b subsection. 1 DBG);
- Natural persons not holding the participation among business assets: exemption equal to 40 per cent if the participation counts for at least 10 per cent of the relevant equity (Section 20 subsection. 1bis DBG);

Dividends received through commercial activity

According to the Corporate Tax Reform Act, the individual shareholder benefits from the participation if he holds the participation among his business assets. The income from the participation is taxable for 50 per cent of the received amount. All connected expenses are deductible. The participation must be at least 10 per cent of the distributing entity´s equity (see Section 18b subsection 1 Direct Federal Tax Act).

Hidden profit distributions

As noted before, also Switzerland has an organic set of rules dealing with the phenomenon of hidden profit distribution. Developed by a leading case of the Federal Court[302] and developed by the academic world,[303] the general definition accepted is:

- circumstances where the company has to bear a cost because of payments to shareholders or related parties;
- those payments are not equal concerning the cost/benefit analysis;
- the actors on the company´s level were aware of the above;

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[302] BGE 82 I 288 (ASA 25, 433).

[303] PETER BRÜHLISAUER AND JEAN KUHN, ART. 58 DBG, marginal reference. 104; THOMAS JAUSSI AND MARKUS PFIRTER AND COSTANTE GHIELMETTI, FREMDFINANZIERUNG IM SCHWEIZERISCHEN UNTERNEHMENSSTEUERRECHT 68 (2010).

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CHAPTER IV. THE EXEMPTION OF GAINS FROM THE DISPOSAL OF SHARES

1. The German implementation of the "pure participation exemption model"

a. Basics of the German rule

Rationale: coherence of the system

Gains resulting from the sale of participations in companies are also 95% tax exempt. This is due to the rationale pointed out by the Tax Reduction Act:[304] the realization of hidden reserves of a company by means of the sale of a participation has the identical economic consequence as a profit distribution and should therefore for tax purposes treated the same way as the distribution of dividends.[305] Accordingly, capital gains are 95% exempt on the level of companies provided that no specific statutory exceptions apply.[306] The notes of introduction to the German tax reform affirm that the implementation of an exemption for capital gains is based on two fundamental principles: first, the exemption for capital gains grants taxation only on the company's level and, secondly, it is intended to be a logical consequence of the exemption of dividends. More precisely, with respect to the second aspect, that aforementioned explanation is based on the theory that capital gains at present correspond to the discounted and actual value of the future dividends referred to the same participations. As those participations bear exempt dividends, either to the extent of 95% with respect to corporate shareholders or to the extent of 50% with respect to individuals, the consequent gain should have, according to the German legislator, the same tax effect of the respective profit distributions. The taxation of the capital gains at the level of the company follows one of the above stated basic aspects of the German tax reform, which

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[304] Steuersenkungsgesetz as published in BGBl on p. 660, 2003.
[305] *ERLE BERND AND SAUTER*, supra note 62, at 775.
[306] *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 18.

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is the introduction of the principle of taxation with reference to objective conditions based on the nature of the company and not based on subjective conditions referred to the shareholder. The Participation Exemption is also necessary to make sure that the taxation applies to the realization of the profit by share deal and not only to the distribution of dividends. With respect to the second aspect, it is hard to express whether that explanation attempt is correct, but for sure there are many authors stating the opposite.[307] It is clear that one of the motivations of the introduction of a mirroring rule with respect to capital gains and the exemption of profits distributed between companies follows a certain model used among many tax systems.[308]

Circulation of the tax model

Keeping in mind that an alternative to the distribution of profits between parent and subsidiary companies is the total or partial sale of participations in the subsidiary company, the partial exemption of capital gains connected to the realisation of participations in companies is a necessary consequence to a Participation Exemption system. The sale of participations is of course only an alternative to profit distribution. The aforementioned thoughts are applicable particularly for non-strategic participations . Under an economical perspective, the gain resulting from the sale of participation is dependent upon the purchase price and a portion of profits retained during the period for which the participation is held, whereas the retained profits contribute to an increase of the value of the respective shares. Hence, at a first glance it appears consistent that a capital gain resulting from the sale of participation is taxed in the same way as the distribution of a dividend, i.e. the capital gains are (partially) exempt from taxation. This is the rationale of Section 8b, (2) and (3) dKStG respectively

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[307] Marco Romswinkel, *Steuerfreiheit von Veräußerungsgewinnen gem. § 8b Abs. 2 KStG systemimmanent?* GMBH-RUNDSCHAU 1059 (2002) expresses doubts, whether the similar taxation of dividends and capital gains can be approved. Roman Seer and Klaus-Dieter Drühen consider the provision not justified, as it can be applied for reserves that were never taxed before. See Roman Seer and Klaus-Dieter Drühen, *Vertrauensschutz bei steuerfreien Anteilsveräußerungen - Verfassungskonformes Übergangsrecht nach § 8b Abs. 4 S. 2 Nr. 2, § 34 Abs. 4 S. 7 KStG*, GMBH-RUNDSCHAU 1093, 1103 (2002); *EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT*, supra note 94, at 17.

[308] *Carlo Garbarino*, supra note 1, at 812.

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Section 3 Nr. 40, a–c, j EStG. The aforementioned rules provide in essence for a 95% exemption of capital gains realized by companies and, according to the so-called half-income taxation, 50% exemption for capital gains earned by individuals.
The justification for the introduction appears logical and might be appreciated by certain taxpayers, but it might be too simple: first, it is not true that dividends carry along only their basic value and a portion of retained profits, but also parts of the company's goodwill and equity formerly taxed in a more favourable way than ordinary profits. Secondly, such a capital gain can also be caused by high prices for the respective share caused by an increase of the stock market price that is often not attributable to a corresponding elevation of the participation's intrinsic value. Moreover, another critical aspect is the introduction of a non-deductible portion of the capital losses realized (see infra), that is justified by an exemption of the income connected to the respective participations. As the Participation Exemption for capital gains has only the advantage of simplification with respect to the former Imputation System, such a non-deductibility provision is not justified.

Another way to explain this is to see the introduction of the Participation Exemption for capital gains as the implementation of a taxation model used by many European countries. In this respect it has to be observed that the Participation Exemption Method for dividend taxation is not only applied in its countries of origin (Belgium and the Netherlands) but also on legislations formerly using the Imputation Systems (Spain, UK, France, Denmark and Austria).

This approach is certainly interesting from the view point of explanation of the selection of a specific tax model, but it cannot be considered sufficient to explain the German legislator's motivation to introduce such a profound reform in this specific moment. In this respect it appears more useful to analyse more deeply such aspects as simplifications and doubts raised by the ECJ, such as the Manninen Case. That case raised strong doubts about the compatibility with EU law of the Imputation System, such as adopted in Finland, which corresponded to the German system in its basic aspects.

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Elements of the exemption

Section 8b (2) dKStG inter alia states that gains from the disposal of shares in subsidiary company, the distribution of which constitutes income within the meaning of Section 20 (1) No. 1, 2, 9 and 10 letter a of the EStG,[309] are not taken into account in the computation of the taxable income of a company . The same refers to the liquidation of the company as well as to the reduction of its share capital as well as in case of a fair value accounting pursuant to Section 6 (1) sentence 1 No. 2 sentence 3 of the EStG.

The basic definition given for the determination of exempt capital gains is the surplus between the book value of the shares and the price received for the same participation.[310] The dKStG does not specify which shares are deemed to be sold, as the system considers that the seller is entitled to decide which shares to sell to the respect of the shares' book value*.* Therefore a corporate shareholder can decide which of the shares held it intends to sell, i.e. it is not obliged by the statute to select a certain package to which a certain book value is attributable. Other legislations present those systems, such as the LIFO, FIFO or the average price method. As mentioned above, a participation does not have to reach a certain minimum percentage, nor has it to respect specific conditions regarding the company in which it is held, to benefit from the exemption.[311] A sale under this circumstance means every profit bearing transaction with respect to shares, regardless of the form of consideration received for the sale if the shares (exchange of shares, cash, etc.). According to a circular by the Ministry of Finance of April 28th, 2003 the exemption concerns gains based on the realisation of both open as well hidden reserves;[312] this means that capital gains can arise from operations under any title. Open reserves are formed by amounts already been subject to taxation, while hidden

[309] This provision states a strict link to the dEStG, stating that all those gains that lead to income from investments under the definition of the dEStG are exempt. The provisions of the dEStG are exhaustive and lead to the perception that all gains connected to the sale of movable investment is exempt under Section 8b, subsection 2.
[310] Begründung zum Regierungsentwurf zu Art. 3, BT – Drucksache. 14/3074.
[311] *MANFRED MÖSSNER AND SIEGBERT SEGER*, supra note 282.
[312] BMF of 28.04.2003 I 292, Tz 2.

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reserves will be taxed in a later moment when the distribution towards the last shareholder occurs.

A preliminary condition for the application of Section 8b (2) dKStG is that the company selling the shares is listed in Section 1 dKStG (*see infra*). As pointed out above, the amount of the exempt gain corresponds to the difference between current book value and purchase price realized. From thisamount the expenses directly attributable to the sale of the shares are to be deducted,[313] since 3c (1) EStG does not apply (see Section 8b (3) KSTG). Losses on the sale and down writings on investments may consequently be not deductible from the corporate income tax base pursuant to Section 8b (3) KSTG. Consistent with this approach, down writings will only be taken to taxable income to the extent the original down writing was at least deductible under the former Imputation System, Section 8b (2) sentence 4 KSTG.

Particular exclusions from the 95% exemption rule were stated by the 4th subsection of Section 8b (2) KSTG. Accordingly, certain shares acquired in a tax-free reorganisation within the meaning of Section 21 German Reorganisation Tax Act[314] (so called "einbringungsgeborene Anteile") at any time in the seven years before the gain was realized[315] are excluded from the 95% exemption of capital gains arising because of the sale of shares and are therefore fully taxable. The intention was to prevent taxpayers wishing to dispose of a part of its assets (such as a business segment) from avoiding the charge to corporate income tax by firstly making a tax exempt contribution of the business segment to a newly set up company (NewCo), the shares of which could then be sold free of tax.[316] Once, however, seven years have passed, it will be assumed that there is no immediate connection between the original drop–down of the business into a new subsidiary with the later sale of the shares in that subsidiary, presenting an interesting opportunity for tax savings. It has to be added that since 2007, the aforementioned tax-free reorganisation

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[313] Section 8, subsection 2, Sentence 1 dKStG.
[314] German Reorganisation Tax Act, from now on UmwStG-D.
[315] Sec. 21 Reorganisation Tax Act.
[316] *HELMUT DEBATIN AND DIETER ENDRES AND MARIUS MÖLLER*, supra note 251, at 96.

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within the meaning of Section 21 German Reorganisation Tax Act[317] (so called "einbringungsgeborene Anteile") has borne the same treatment as before the introduction of the Participation Exemption and this concept is only valid for already existing participations.

b. Scope of the rule

Structure of the exemption

Section 8b (2), (3) of the new German KSTG (KSTG in the form of StSenkG of 23.10.2000)[318] introduces a 95% exemption of capital gains realized through the sale of shares in a German or a foreign corporate body. The provision is illustrative of the change in system from one of imputation to one of 95% exemption.

Generally speaking, Section 8b (2) CITA, a complex rule indicating (or at least linking to other provisions in case of current definitions) that in general, capital gains from the sale of participations in companies or partnerships, held by companies subject to a limited or unlimited tax liability are exempt from German corporate income tax. Corporate shareholders benefit from this rule. There is a wide scope of application, including the companies in which the shares are held and the types of shares included in the exemption provision. Section 8b (2) CITA continues by telling the conditions to be met for application of the rule itself, both with respect to the shares themselves and the company the shares are complied with.

The 95% exemption is granted under the condition that the gain realized through the share deal is based on reserves which have already been taxed or stay in the scope of application of the KSTG after the share deal.[319]
This means that capital gains from the sale of shares are, in principle, 95% exempt from corporate income tax and trade tax. Only 95% of the respective

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[317] RTA - D, from now on RTA – D.
[318] StSenkG, published in BGBl 2000, I, 1433; BStBl 2000 I 1428.
[319] See supra for differentiation between hidden and open reserves.

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capital gains from the tax year 2004 on are tax exempt, since 5% of the net capital gains are deemed to be non-deductible business expenses. The exemption is granted to both direct participations and indirect participations (e.g. through a partnership), and irrespective of whether the company in which the shares are held is resident or non-resident. There is no minimum participation requirement, nor any minimum holding period, except for certain restructuring situations (7 years).[320] The exemption is not granted to the extent that the holding has previously been written down to its lower fair market value and has not subsequently been written up again. Capital Gains on shares held by banks, financial service institutions and finance enterprises for trading purposes are not tax exempt under Section 8b (2), see Section 8b subsections 7 and 8, KSTG.

Participating persons

According to the circular by the Ministry of Finance of April 28th, 2003,[321] a 95% exemption for capital gains is granted to all kinds of legal persons, subject to the KSTG. The dKStG starts by listing the subjects falling within its scope of its application. dKStG does not apply only to companies, but also to other corporate bodies of private or public law such as associations without an own legal personality.

On the other hand, the companies benefiting from the rule are those limitedly subject to German Corporate income tax; non-resident companies. It has to be added at this stage that, within the orbit of limited tax liability, German tax law does not necessarily follow the position taken abroad. Thus, a foreign legal definition of a body as a legal person will only be followed in Germany if, by its nature, the body is closer to the German concept of a company or to that of a partnership. If the first is the case, the body will be seen as subject to corporate income tax and granted full exemption with respect to capital gains.If the second is the case, it will be seen as partnership with consequential exemption equal to fifty per cent of the realized capital gain.

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[320] Section 22 (2) RTA – D.
[321] BMF - Circular for Section 8b, subSection 2 dKStG, 28.04.2003, published in BStBl. I 292.

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The exemption is valid for both resident and non-resident companies and irrespective of the percentage of share held by the controlling company. The rule comprises also capital gains from the sale of a participation in a subsidiary company even in the following cases: a consolidation for tax purposes, the reduction of capital, the impairment procedure, goodwill and hidden contribution. Explicit quotation is made with reference to capital gains deriving from the sale of own participations, also included is the sale of a subsidiary company's participation in the controlling person with respect to a consolidation for tax purposes. A particular case is dTUIRted by the so called 7 years rule which deals with revaluations of participations formerly written down: the standard regulation states the irrelevance of down writings in profit taxation. The deductibility of the revaluation is mirroring with reference to taxation. Full irrelevance is given to it from this tax perspective. Ifs the capital gain is taxable at the moment of the transaction, down writings from the profit realized[322] become deductible.

Persons subject to the dKStG

The German Participation Exemption system differs from other Participation Exemptions in other European countries: gains from the sale of shares in a company carried forward by an individual benefit from a treatment similar to the treatment of companies selling shares in other subsidiary companies. In cases other than corporate reorganizations, capital gains realized by individuals on the sale of shares held in German or foreign companies are only taxable if the shareholding is deemed to be speculative or if the individual holds a certain share percentage in the respective share capital. Gains on the sale of shares are deemed to be speculative if the sale is no later than one year after the date of purchase. A taxable gain on the sale of a substantive share (Section 17 (1) sentence 1 EStG) occurs if the individual sells shares of a company in which he directly or indirectly held 1% or more of the issued share capital at any time during the immediately preceding five years. However, if taxable at all, only one half of the gain realized will actually be charged to tax under the 50% exemption method. The reduction from the level of significant investments,

[322] marginal reference 18 and 40 ff.

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equal to 10 % before the latest tax reform to a relevant 1 per cent holding increases the scope of taxation of long term gains from the sale of shares by private individuals to the extent that for the sale of shares in smaller companies this will now become the general rule. This widening of the scope of application follows from the consideration that otherwise the lower tax burden on retained earnings would tempt shareholders to accumulate earnings in companies with a view to a subsequent realization through tax exempt capital gains. When closing this loophole, the legislator accepted further restrictions on the fundamental exemption from taxation of value increases of privately held assets. The taxation of share disposal applied to a reduced level of significant investments from 2002 on, assuming the company which issued the sold shares has the calendar year as its fiscal year. If, however, the company's fiscal year is different, the date from which the new rules will be applied is advanced accordingly.

The extension of the definition of a significant investment from one of 10 % to one of 1 % will move many individual investments previously held in the belief that any subsequent sale would not be affected by income taxation. This also could mean that previously irrelevant value appreciations within the private sphere will have potentially serious tax consequences in retrospect.

In order not to burden individuals as shareholders with greater tax obligations on the sale of their shares than they would have borne had they taxed dividends under the 50% exemption method, taxable gains realized by private individuals from the sale of a "significant" holding will only be charged to taxable income as to one half (Section 3c (2) EStG together with Section 3 Number 40c EStG). This also applies to short–term gains from speculation (Section 23 EStG) and gains on the sale of shares held as business assets by sole traders or partnerships. On the other hand, losses, down writings and expenses of disposal are only deductible as to one half (Section 3c (2) EStG). As an exclusion to the general rule, any extraordinary down writing previously deducted from taxable income will be recaptured in full, whether by write back to reflect a subsequent increase in value or as part of the capital gain on sale. Certain types of shares issued in the course of corporate reconstructions will

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only qualify for 50% exemption on disposal after a waiting period of seven years.[323]

The changes in the law mean that private persons wishing to sell shares from a "significant" investment under the previous definition will be in a more favourable tax position if they can defer the realization of a capital gain until the advent of the 50% exemption method in 2002.

Participated persons and categories of shares

As said above, capital gains from the sale of shares in a domestic or foreign company held by a domestic company or as an asset of the German permanent establishment of a foreign company are not taken to taxable income (special provisions are expected to apply for banks and financial service companies with respect to their current profits from trading activities).

There is no minimum holding period necessary to benefit from the German Participation Exemption with respect to capital gains. The only exception applies to participations to so called *einbringungsgeborene Anteile*: if that operation was put in place in fiscal neutrality, there is a minimum holding period of 7 years to make the exemption applicable in cases of sales of the participation.

There are no minimum levels of shareholding and no business activity restriction. The tax exemption applies from 2002.
The converse of this fundamental exemption of capital gains on the sale of shares from taxation is that corresponding losses or down writings will no longer be deductible.

This capital gains exemption can be seen as the extension of a previous exemption in respect of most foreign investments to domestic investments. With respect to the 95%/partial exemption for dividends, this exemption is not lost if the investment is indirectly held through a partnership (e.g. Section 8b (6) KSTG, transparent view principle).

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[323] Section 3 Nr. 40, subsection 2, dEStG.

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German lobbyists had often asked for an exemption of such nature, as one of their objectives in the phase of globalization and focus of worldwide markets was to cut the long existing chains of control in German public companies and to sell those participations of non-strategic interest, which had been bought in a period of creation of very large conglomerated groups during the 1980's.

The Participation Exemption on capital gains from the sale of shares, issued by a subsidiary in exchange for an asset contribution of a business unit at book value will not be granted during the first seven years following the reconstruction. Since the provision tends to put companies and individuals with multiple business lines or branches at a disadvantage over corporate groups, German companies might consider enhancing their freedom of action for the future by reconstituting their individual business units and partnership holdings as subsidiaries. This can be done tax exempt as asset drop–downs under the Reconstruction Tax Act.

From the perspective of the subjective scope of application, Section 8b (2) dKStG indicates the subjects benefiting from the exemption provision in their function as controlling companies and those in their position as subsidiary companies. The same Section states that the Participation Exemption applies to gains from the sale of participations in legal persons and partnerships.
The nature of the rule itself determines a scope of application referred to the debtor that includes, except for a link to partnerships (see infra), companies subject to the corporate income tax which, according to Section 1 of the KSTG[324] are: companies (public companies, partnerships limited by shares, private limited companies); purchasing and business cooperatives; mutual insurance associations; other persons of private law; associations, foundations, trusts and other estates of private law; business of public authorities.
The provision carries on stating that the "the unlimited corporate income tax liability applies to all forms of income". With regards to the definition of residence, the law rules that "Germany within the meaning of this act includes the portion of the continental shelf falling to the Federal Republic of Germany

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[324] Section 1 of dKStG.

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insofar as exploration or exploitation of resources occurs on or below the seabed".

With respect to the meaning of "limited or unlimited tax liability", it has to be mentioned that German tax liability, including the liability to corporate income tax, is either unlimited or limited. Unlimited tax liability presupposes taxation by reference to the entire income wherever earned, limited liability encompasses income earned within Germany only. Essentially, a taxpayer is unlimitedly subject to taxation, whereas a non-resident falls under the limited liability only.[325] Participations held by permanent establishments of foreign investors in Germany are within the scope of application of Section 8b, subsection 2 KSTG.

In general, it is not relevant whether the subsidiary company is resident in Germany or not. This circumstance, although not stated directly, derives from two facts: first, no specific calculation rule for the determination of non-deductible interest is given in Germany, and more specifically a flat non-deductible portion is made compulsory for every kind of dividend income; second, the abovementioned limitation is applicable[326] to every person within the scope of application of Section 8b, subsection 2 KSTG. A German particularity is the type comparison, a verification of the applicability of the Participation Exemption to be carried forward comparing the nature of the participated company.

On the side of the controlling companies, it has to be stated that persons granting from the exemption provision are those limitedly and unlimitedly subject to German corporate income tax.
The Participation Exemption for income from capital gains applies to all taxpayers who are limitedly or unlimitedly subject to German corporate income taxation.[327] There are no subjective limitations, the form of company is not relevant. No importance at all is given to the activity put in place by the participating company. Also holding companies, private equity companies and

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[325] HELMUT DEBATIN AND DIETER ENDRES AND MARIUS MÖLLER, supra note 251, at 80.
[326] *Francesca Cirrincione and Francesco Spinoso*, supra note 274, at 83.
[327] Sections 1 – 4 dEStG.

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investment funds are within the scope of application of the rule and therefore hit by the application of the non-deductible portion.

Furthermore, the provision is applicable to companies no matter of their place of residence and not depending on the fact of the participation itself is part of the capital of the permanent establishments in Germany, held by foreign companies. It does not matter if a foreign taxation is applied to the foreign participating company and its shareholders.[328] Also in this respect, an isolated analysis of the participation is compulsory, being gains and losses from different sources not credited one against the other.[329]

It has to be pointed out that, according to Section 8b (3) KSTG, down writings with respect to potentially exempt participations are not deductible from the other net income of the parent company. This follows a principle of correspondence according to Section 8b (2), which states[330] that the introduction of the Participation Exemption determines a non-deductibility for down writings referred to exempt participations.

The exemption for capital gains resulting from the sale of participations is applicable whatever the country of residence of the subsidiary company. The same treatment is granted in cases of German resident parent companies, which hold a participation in a person resident outside the German territory. Except for cases of the application of the CFC rules according to Section 7 ff., AStG (*see infra*), there is no different treatment with respect to resident subsidiary companies.

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[328] MICHAEL STRECK, KÖRPERSCHAFTSTEUERGESETZ 325 (2005).
[329] See Regierungsbegründung, BT – DRUCKSACHE 15/1518 of 8.9.2003, at 15.
[330] MANFRED MÖSSNER AND SIEGBERT SEGER, supra note 282, marginal reference 25.

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c. Requirements for the exemption

Symmetry between exempt gains and non-deductible losses

According to Section 8b (3) KSTG, reductions in profits from the down writings of the shares named in subsection 2 to their lower fair market value or from the disposal of those shares or following the dissolution of the company or reduction of the share capital, are not to be taken up into the computation of income. The meaning of this subsection is that down writings do not benefit from a symmetric treatment[331] as gains or profits deriving from shares matching the conditions of Section 8b (2) KSTG: down writings are not deductible and, consistently, up writings are taxable only if the former down writing was deductible under the replaced Imputation System.
The provision leads to some complications as, in cases of losses on the corporate level, the shareholder bears a reduction of the shares' value as well. Because of the circumstance that a former profit was taxed only on the corporate level and therefore 95% or 40% exempt on the level of the shareholder, the arising loss is deductible only on the level of the company and not on the one of the shareholder, according to Section 8b (3) KSTG, creating some economic problems in terms of competitively of German companies. Despite this, the rule on the treatment of losses connected to exempt participations as of Section 8b, CTA - D is coherent and symmetric from a legal perspective.

Non-deductibility of capital losses and related expenses

Sentence 3 of subsection 3, Section 8b dKStG rules that losses arising in connection to gains as of subsection 2 of Section 8b dKSTG are not deductible. This determines a corresponding non-deductibility of capital losses for companies subject to the German corporate income tax, as well as the non-deductibility of down writings linked to the same participations. In this case, the Participation Exemption for capital gains and dividends has a correspondent

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[331] REICH IN BLÜMICH, KÖRPERSCHAFTSSTEUERGESETZ KOMMENTAR, §8B KSTG marginal reference 132.

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element given by the non-deductibility of costs connected to the same, potentially exempt shares.
Among classical systems for dividend taxation, a non-deductibility provision with respect to capital losses represents a necessary consequence[332] to the exemption granted to specific participations, exemption that again can be seen as consequence to the exemption of dividends.
This is certainly explained by the circumstance that, assuming that dividends and capital gains are exempt under a Participation Exemption because of profits were not formerly distributed but carried forward elevating the value of the participation, the first consequence must be the exemption for capital gains under the same conditions and in the same percentage as valid for dividends (although some authors consider this approach simplifying)[333]. The second necessary effect should logically be that capital losses connected to the aforementioned participation should not be considered in the calculation of taxable income as well as down writings of the participations themselves.

It is positive that, in difference to the technique adopted by other European legislators, the non-deductibility statement is made in a clear way, directly included in the same participation provision.

Deductibility of expenses referred to exempt participations

After some systematic problems that had arisen when the treatment of expenses linked to exempt capital gains realized by shareholding companies was defined in an unclear way,[334] the actual legislative conduct of those expenses prescribes a full deductibility of the expenses sustained in connection with those exempt participations,[335] although there is a fiction of costs for an amount equal to 5 per cent of the dividend.
In fact, before 2003 the German legislator decided to apply the general non-deductibility provision of Section 3c, subsection 1, EStG to expenses connected

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[332] *CARLO GARBARINO*, supra note 2, at 845.
[333] EWALD DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT, supra note 94, at 12.
[334] *Dötsch*, supra note 132.
[335] See Section 8b, Subsection 3, Sentence 1 dKStG.

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with the management of potentially exempt participations. In 2003, the general non deductibility portion equal to five per cent of the capital gain was introduced (*see* infra). A particular treatment is prescribed for losses connected with those participations (*see infra*). An important distinction at this stage is to be effected between expenses directly connected[336] to the sale of the potentially exempt participation,[337] that are subject to the disallowance provision of Section 4 EStG, and expenses arising in the normal management of the participation and not connected to an eventual tax exempt sale of the latter.
Corresponding to the last rule mentioned, the capital losses are subject to the deductibility limitation only if directly connected with the sale of a participation.
All other expenses connected to the current taxation of a participation held by a company bear a limitation with respect to connected expenses, equal to five per cent of the arisen expenses, as prescribed by subsection3, Section 8b KSTG.

"Directly assignable accessory costs"

As mentioned above, expenses directly imputable to a transaction falling within the scope of application of Section 8b, subsection 2 KSTG are deductible from the capital gain realized and bear only a standard non-deductibility portion equal to five per cent of the amount of the capital gain.
Interest paid to finance this kind of operation does not fall within this deductibility provision.[338]
Therefore the relevant amount of the exempt capital gain is given by the difference of the purchase price and the book value minus the expenses directly imputable to the operation. Such expenses can be expenses for legal or tax counselling, made necessary for the particular operation itself. Notary expenses for the operation are included as well. Some particular operation can make

[336] These expenses are especially those for legal and fiscal counseling and notary expenses, see BMF – Circular of April 28th, 2003.
[337] Expenses linked to a participation with respect to Section 8b, subsection 2, dKStG bear the same treatment only if they aren't by case excluded from the exemption rule (e.g. companies generally exempted from taxation because of special legislation), see *EWALD* DÖTSCH AND WERNER JOST AND ALEXANDRA PUNG AND GEORG WITT, supra note 94, at 128.
[338] See BMF – Circular of 28.04.2003.

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special financial advice necessary as well as particular studies on the convenience and the feasibility of the operation itself.

Of course, as the capital gain itself is exempt, and only taxable by a rate corresponding to five per cent of the realized net profit, such expenses bear a less favourable treatment than normal expenses for the management. This is explained by the following example:

According to subsection3, Sentence 1 of Section 8b KSTG, five per cent of the gains imputable to the operation have to be fixed as non-deductible expenses. This, incidentally, does not mean that the relevant deductible expenses are reduced or that the relevant capital gain has to be elevated. It simply means that the respective tax assessment will have to include an additional positive position being equal to 5 per cent of the gain itself.

Operations concerning equity

In the case of the objective limitation with respect to the exemption of capital gains, the relevant (*see supra*) letter by the Ministry of Finance states that this limitation applies to cases where a legal person obtains shares from a subsidiary in exchange for the contribution of a business formerly detained by the parent company. That case could transform taxable income into exempt contributions according to Section 8b, subsection 2 KSTG.

This limitation, stated by subsection 4, Sentence 1 of Section 8b KSTG is applicable only to contributions made before the introduction of the anti – abuse provision itself, which occurred in 2004.[339]
It is problematic that the relevant moment for the application of the exclusion provision is the sale of the participation, as contributions of businesses put in place before the new rule can hardly be explained by suspicion of anti – avoidance practices. As this is clearly an anti–abuse provision, it is worth mentioning that it must be judged under the basic rule that such an avoidance practice is only suspected if clearly intended. This avoidance intention must be

[339] DÖTSCH in DÖTSCH AND PUNG, supra note 162.

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proven by objective criterions. There are strong doubts as to whether these conditions are matched by the wording of the anti-avoidance provision.
The exclusion does not apply after a period of time equal to seven years from the moment of contribution to that of the sale of the participation.

The rule applies only to contributions made at book values according to Section 20 to 21 Reconstruction Act. That rule of the Reconstruction Act has the objective of a carry–forward of taxation with respect to the contribution of participations or goods. Such taxation must be put in place in the moment of the sale. The exclusion provision aims at excluding that hidden reserves contributed to a new company in fiscal neutrality remain untaxed through a sale in the form of Section 8b, subsection2 KSTG.
This leads to the following categories of cases:

Exclusion cases stated by Section 8b, subsection4, Sentence 1 and leading to a full taxation of the capital gain are the sale of participations, obtained for the contribution of businesses, parts of businesses or participations in partnerships, according to Section 20, subsection1 Reconstruction Act, within a period of time shorter than seven years from the moment of the contribution; and the sale of participations, obtained for the contribution of businesses or parts of businesses, according to Section 23, subsection1 to 3 Reconstruction Act, within a period of time shorter than seven years from the moment of the contribution.

This means that there could be an exclusion even for the sale of participations in companies, if they are held as part of a contributed business or participation in a partnership. The relevant circular of the Ministry of Finance[340] recognises this rule as contradicting the rationale of Section 8b KSTG- D and states that an exception can be reached from the exclusion under the following conditions:

The contributed participation must be a majority; the participation can't represent more than fifty per cent of the contributed business's value; the relation between the contributed participation and the obtained shares must

[340] BMF – Circular of 28.04.2003.

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correspond to the relationship between the residual business and the obtained shares.

Participation exemption for capital gains and determination of the tax base in the personal income tax

This part of this thesis observes both the case of individual shareholders holding a significant participation in an enterprise, if the treatment follows the typical function of a Participation Exemption system, as well as individual shareholders holding less than one per cent of a company's shares, a case where a total exemption is applicable. That last complete exemption is a special measure that existed even before the introduction of Participation Exemption in Germany, going –against a simpler and more favourable treatment of small private investors.

With respect to investors holding significant participations, and corresponding to the aforementioned rule as regards the deductibility of capital losses connected to 95% exemptions for persons subject to the corporate income tax, individuals carrying their participations within a business activity are treated in a way dTUIRted by the same logical approach. Since Section 3 No 40 EStG states that profits arising by means of the obtainment of dividends or similar titles are 50% exempt, and since the same Section of the EStG introduces a provision stating that capital gains received by individuals or partnerships throughout the profits of a share deal are exempt for an amount equal to 50 per cent of the received capital gain, the treatment of capital losses or down writings is analogous and sets a non-deductibility portion of 50 per cent of the respective capital loss or down writings, see Section 3c (2) EStG.
It can therefore be stated that the deductibility criterion applied is different, but follows, however, the same systematic approach used for the tax treatment of the respective losses realized by company holding participations in other corporate companies.

Treatment of capital gains not qualifying for the Participation Exemption

The Participation Exemption for capital gains deriving from the sale of certain participations effected by certain persons makes it necessary to broaden the view on the whole system and briefly mention also cases of capital gains

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eventually not exempted. As mentioned above, companies subject limitedly or unlimitedly to German corporate income tax selling participations to companies again limitedly or unlimitedly subject to German corporate income tax plus participations in partnerships, whose partners are liable limitedly or unlimitedly to German income tax, are exempt. Participations which are held in companies resident in countries with *significantly lower taxation on passive income* according to the AStG, Section 7 to 14, have the consequence that profits of the interposed subsidiary company are attributed by means of the *CFC taxation* as of Section 7 ASTG-D through a fiction of distribution towards their ultimate German resident shareholders.
It can therefore be stated that the most appropriate approach to the analysis of the scope of application of the German exemption rule with respect to capital gains realized by companies subject to the corporate income tax is the one affirming that all capital gains are exempt with the following exceptions plus the case of *imputation taxation* applicable to all kinds of shareholders.

The basis still remains that all capital gains as of subsection 2, Section 8b dKStG remain exempt. The two following cases should determine a rule avoiding cases in which a taxable participation is transferred into the capital of a company that could then sell it tax exempt.[341]
Both exclusions from the exemption are closing in the sense that cases not treated by those rules stated by Ministry of Finance’s circular are included any case if matching the conditions stated by Section 8b, subsection 2 KSTG.

[341] BMF – Circular of 28.04.2003.

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2. The limitations on the exemption in Italy

a. Basics of the Italian rule

Rationale: Coherence of the system

The economic and legal purpose of capital gains exemptions for share deals is as follows:
The exemption for capital gains states the principle of exclusive taxation of the company and not of the shareholders as well. Secondly, the rule is a necessary consequence of the Participation Exemption model referred to dividends. With respect to the first principle, some authors state that there is substantial interaction between capital gains and the discounted actual value of earnings retained by the same company. Sooner or later these reserves emerge and are subject to taxation. There is no systematic reason to treat capital gains different from dividends. Moreover a taxation of capital gains would result in a double taxation, analysing the specific situation of the shareholder as well. Furthermore, the Participation Exemption for capital gains guarantees that those funds are taxed on the level of the corporate company and not on the level of its shareholder. The legal person is therefore no longer a company anticipating the shareholder's taxes, but an own centre of production for relevant income with a consequent taxation independent from that of the shareholder. Both principles are certainly elements of the aim of the tax reform to concentrate the taxation of business profits on the level of the person effectively producing the relevant profit, or in this case the legal company receiving a dividend or producing a capital gain. Again, the capital gain is intended to be treated as exempt because of the circumstance that it is seen as a substitute for an ordinary dividend distribution.[342]

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[342] Ballancin/Caimi, *Comprehensive tax reform before the Italian parliament*, EUROPEAN TAXATION 358 (2002); Garbarino Carlo, *Persone fisiche residenti, il nuovo regime dei dividendi di fonte estera*, Fiscalità Internazionale 215 (2004); Garbarino/Panteghini, *Corporate Taxation in Europe: Competitive Pressure and Cooperative Targets*, International Taxation Handbook (2006); Gariboldi, Starita, *Participation Exemption in Italian Tax reform*, 32 INTERTAX (2004); Sebastiano Garufi, *La tassazione dei dividendi in capo alle persone fisiche nel mercato interno*, FISCALITÀ INTERNAZIONALE 147 (2004); Marco Magenta, *La Participation Exemption relative ai dividendi nella riforma fiscale*, FISCALITÀ INTERNAZIONALE 435 (2003); Raffaello Russo, *International aspects of the proposed corporate tax reform – a comment*, in EUROPEAN

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Circulation of the tax model

Another reason for introducing the Participation Exemption for capital gains in Italy is the reception of a taxation model circulating among European countries. In this respect it has to be observed that the classical method for dividend taxation has expanded from its original tax systems of application (Belgium and the Netherlands) and is now valid in legislation coming from a history of Imputation Systems (Spain, UK, France, Denmark and Austria).[343]

At this stage it can be affirmed that, from a comparative point of view, all the European Participation Exemption models have certain typical functions (simplifications of share operations, introduction of a special rule incentivising holding companies), and to avoid double taxation is usually not one of them. It can therefore be stated that the convergence between the European applications of the circulating model Participation Exemption is only partial, because of the fact that Italy, for example, does not require a minimum participation for the application of the full exemption of capital gains.

This approach is certainly interesting because of the explanation as to why to select a specific tax model, but cannot be considered sufficient to explain the Italian legislator's motivation to introduce such a profound reform in this specific moment. For that issue it appears more useful to analyse more deeply such aspects as simplification and doubts raised by the ECJ, such as the Manninen Case.[344] That case raised strong doubts about the compatibility of the Imputation System in Finland (which corresponded to the German system in its basic aspects) with EU law.

TAXATION 304 (2003); Flora Serbini, *New dividends and capital gains regime*, EUROPEAN TAXATION 122 (2004); Giuseppe Tesauro, *Aspetti internazionali della riforma fiscale*, FISCALITÀ INTERNAZIONALE 427 (2003).

[343] *CARLO GARBARINO*, supra note 1, at 814.

[344] ECJ, 7.9.2004, C -319/02.

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<u>Determination of the value referred to the exempt participation</u>

The Italian tax system presents different rules with respect to gains from the sale of goods belonging to the enterprise: Section 86, subsections 1, 2, 3 state that goods belonging to the enterprise cause gains, if they are sold, if they are realized by refund or if they are designated to uses differing from the ordinary business activity. Section 87 TUIR states that capital gains determined according to Section 86 TUIR and referred to the companies and shares mentioned above are exempt. This focuses the attention on the definition of the realization of those capital gains, i.e. the sale, the designation to shareholders and the use for purposes different from the ordinary business activity. Transitory contracts not transferring shares in an ultimate way do not correspond to realization. Operations that transfer the rights connected to those shares, different from the sale such as transfer in the capital of a newco, exchanges, etc. do represent relevant transfers according to Section 9, subsection 5 TUIR. Another operation causing the realization of capital gains is the transfer of the company's place of business to a foreign country. This according to Section 166, subsection 1 TUIR.

The basic provision in the Italian Income Tax Act with reference to the determination of capital gains exempt from taxability, is included in Section 86: Section 87, which is the applying Participation Exemption provision for capital gains, states that capital gains have to be determined according to Section 86. The next element of the provision is the statement that those capital gains matching the additional conditions of the same Section are exempt. Section 86 prescribes that in case of capital gains caused by realization (Section 86, subsection 2, lit a), the capital gain is given by the difference between the received amount (price or consideration), reduced by the expenses directly linked and the book value of the participation, while in the case of lit c) of the same Section (destination to scopes outside the business activity) the capital gains is given by the difference between fair market value and the book value of the participation). Section 87 TUIR also includes stock in the sense of Section 44 TUIR and contracts as of Section 109 TUIR.

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b. The limitations on the exemption of gains

Structure of the exemption

As mentioned above, the most important element of Section 87 ITA in its renewed form after the tax reform is the simple statement that capital gains do not bear taxation. Of course such a statement is directly linked to a structure of conditions to be met by the company selling stock and by the company the stock is held in. In the case of the Italian legislation this set of rules is rather organic and complex. The exact determination of the scope of the provision is important: the conditions to be met by the participating companies benefiting from the exemption, by the shares and the companies the shares are held in, other conditions with reference to the nature of the held stock and the nature of the companies the stock is held in.

Persons subject to the Corporate Income Tax

According to Section 87, subsection 1, TUIR, capital gains, determined according to Section 86, subsection 1,2,3 TUIR are exempt for resident companies and other companies with legal personality with reference to participations held in companies and companies indicated in Section 5 TUIR (partnerships and joint stock partnerships) and companies as of Section 73 TUIR (companies, LLC's, companies with legal personality), whether resident or not, with the exclusion of partnerships not carrying forward commercial activity (società semplici). Participations not represented by stock are included under the condition that they meet the other clauses stated by Section 87 TUIR.
As it is part of the title with respect to corporate bodies subject to company tax (IRES), Section 87 TUIR includes in its scope of application companies and resident commercial companies by definition. The following persons are considered participating companies with the consequent application of the Participation Exemption with respect to capital gains: companies, LLC's, partnerships limited by shares, cooperative societies, mutual insurance companies and private and public companies with legal personality having commercial activity as main object. Included by the link to Section 58, Sub – Section 2 TUIR stated in Section 87 TUIR are partnerships, special partnerships and individuals carrying on business activity. One last category of subjects included in the scope of application of the Participation Exemption provision

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applies to foreign companies of any type having booked the relevant participation in an Italian permanent establishment. In these aforementioned cases the exemption is equal to 84% of the capital gain, the consequence is a difference between the income for accounting purposes and the taxable income. This exemption is justified as long as the relevant capital gains are maintained on the level of the participation, while they become taxable if the capital gain is distributed to the company's individual shareholders in the form of a dividend. As stated above, the circumstance that capital gains in the view of the legislator and the Central Tax Agency correspond to dividends and should therefore bear the same treatment, is questionable[345]. Continuing, the exemption is not applicable to public and private companies, both resident and not resident, that do not carry forward business activity with reference to their prevalent activity. Those companies bear a separate treatment for each of their activities, corresponding to the treatment of private investors, although they apply the ordinary company tax rate equal to 33%. The exemption provision is not applicable to those taxpayers that benefit from simplified provisions with respect to their accounts, as they are not obliged to hand in ordinary accounting data, they are not in the condition to determine the book value of their participations correctly.

c. The requirements to be met for the exemption

Persons subject to the personal income tax which carry commercial activity

In the case of individual shareholders holding their participations within a business activity, the first step is to check if the participation is really one of the objects of their business activity: this is put in place according to Section 2217 of the Civil Code, which states that goods belong to the business of the individual, if they are included in the inventory. For companies with simplified accounting rules as of Section 65 TUIR, the aforementioned inclusion in the inventory can be substituted by an inclusion in the list of amortizable goods or in the list of goods held for VAT purposes. Individual shareholders holding their participation within a business activity and partnerships obtaining an exemption

[345] See *Carlo Garbarino*, supra note 2, at 817.

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of the capital gain by sale of a participation meeting the requirements of Section 87 corresponding to 50,28 % of its amount, becoming subject to a taxation corresponding to 49,72 %.

With reference to the residual category of individuals holding the participations for investment purposes, Section 67, subsection 1, lit c) and c)-bis states that these gains are considered different income[346]: the sale of qualified and non-qualified participations in companies as of Section 5 TUIR, excluding association as of subsection 3, lit c) and in companies as of Section 73 plus the sale of options for those aforementioned operations. For the exact definition of qualified and non-qualified participations, see above. Again, the relevant capital gain is determined by the difference between the received price and the cost for acquisition, having previously deducted directly linked expenses, excluding interest.

Capital gains referred to qualified participations

According to Section 68, subsection 3 capital gains from the sale of qualified participations are taxable for 49,72 % of their amount. Capital losses are considered by the provision in the following sense: capital losses are deducted from capital gains with reference to the same object in order to determine the relevant gain or loss. If the result of the aforementioned calculation is a capital loss, this loss can be deducted for 49,72% of its amount. It can also be carried forward but only for a period of four years beginning with the fiscal year of the determination. The relevant moment for the decision whether to apply the old or the new rules is that of payment. Rules effective at the time of payment are to be applied.
Other specific rules of course determine a full taxability of the capital gains: this is the case of Section 167 TUIR which states that capital gains realized through the sale of participations in companies resident in black list countries have to be taxed for 100% of their amount, except for cases of rulings proving that the

[346] With respect to individuals, this category of income applies to income other than included in other standard categories of income, as income from capital, from movable property, from labour. Capital gains are characterised by this residual class of income.

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localization of the subsidiary company did not have the effect of bearing a significantly lower taxation than in Italy.

Capital gains referred to non qualified participations

As stated above, Italy presents specific favourable tax rules for the taxation of private investors. A private investor is an individual person who holds a non-qualified participation. In this case the taxation of capital gains is equal to 12,5% flat of the amount realized, according to Section 5, subsection 2 of Decree 461/1997. As an alternative, there are various innovative regimes with respect to the taxation of income from investments managed by financial institutions. The relevant moment is given by the payment again, in this case referred to every single payment in case of instalments. The provision included among the former rules, which presented the possibility for the shareholder to choose between being taxed by 12,5% flat tax or by the regular tax on the capital, is no longer present in the actual set of rules. It is not relevant where the participated company is resident. Capital losses referred to the same participation are recognized in the same manner, stated above.

Participated persons and categories of shares

After having analysed the requirements with respect to benefiting subjects from the rules included in Section 87 TUIR with its various links to other rules of the Italian Income Tax Act, a precise analysis with respect to the benefiting subjects is due in the following paragraphs.
Following the logical approach of the legislator in Section 87, the emphasis is put on the categories of participated companies and the nature of the titles held in one of these companies. Literally, the rule as of Section 87 states that
"[...] taxed for 95% of their amount are capital gains realized or determined according to Section 86, subsection 1, 2 and 3, related to stock held in companies and companies listed in Section 5, excluding companies not carrying forward business activity and similar companies, and those of Section 73 TUIR, including those not represented by stock […].
Bearing in mind that the aforementioned conditions are to be considered additional with respect to those of Section 87 mentioned before, it must be said that the participation provision is applicable to sale operations with respect to participations in companies, cooperative societies, mutual insurance societies,

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partnerships, limited partnerships, including factual companies carrying forward business activity and non-recognized associations and consortiums. As the scope of application of the Participation Exemption rule with respect to dividends and the one with respect to capital gains differ and therefore exempt dividend payments could occur at the same moment as deductible capital losses, the Italian legislator introduced an innovation stating that capital losses occurring with reference to stock as of Section 101 TUIR, which are not within the scope of application of Section 87 and therefore fully deductible, are not considered for tax purposes with respect to an amount equal to the dividends received in the same fiscal year and the one before.
The conditions referred to the nature of the securities the participation is formed of are the following: participations in companies, shares in companies, securities similar to shares as of Section 44 TUIR and joint associations with contributions different from labour force or rendering of services. Section 44, subsection 2, lit a) considers similar to shares those securities that present a remuneration totally formed of a contribution in the participated company's profit, in the profit of another group member or in the profit of the business in relation to which the shares were emitted. Titles not yet secured are included in the scope of application of the rule.
With reference to participations in foreign companies with participation not represented by shares, Section 44, subsection 2, Lit a) states that these shares are considered similar to shares in resident companies, if the relative remuneration would have been completely non-deductible for Italian participated companies paying a dividend, according to Section 109, subsection 9 TUIR. This Section states that remunerations are not deductible, if referred to securities of any kind, linked to the economic result of the distributing company or another company of the same economic group. As stated above, the Participation Exemption provision applies also to joint associations. This means that the following participations meet the definition of instruments similar to shares as of Section 44 TUIR and benefit from the Participation Exemption rule as of Section 87, subsection 3.

These are: financial instruments, both secured and not; participations in the capital of non-resident companies; shares or securities that are remunerated by participation in the distributing company's profits; joint associations, if the contribution is different from the rendering of manpower or the provision of services.

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Other cases of joint activities that do not present the contributor's right to participate in the company's capital, it is worth mentioning, are not within the scope of application of Section 87 TUIR.

Companies holding own shares are within the scope of application of the Participation Exemption provision with respect to capital gains, if the conditions referred to the classification and the holding period are met.
In case of an obligation according to Section 2357 ff. with reference to the sale of shares, the respective capital gains become fully taxable, if the conditions of Section 86, subsection 4 apply. If the conditions of Section 87, subsection 1 are met, the exemption provision included in the aforementioned provision is applicable and the capital gain is again exempt from taxation. In cases of convertible bonds and own shares referred to operation between financial institutions and companies in economic crisis, according to Section 113 TUIR, the exemption provision must not be followed on request of the participating intermediaries, if the object of the transaction is a corporate restructuring. If the response of the tax authority is positive, the respective capital gains can be divided into instalments.
The sale of the aforementioned rights can be within the scope of application of Section 87 TUIR, if the rights are sold by the owner of the participation or the holder of proprietary rights, in case of division of these rights from the original security. This is caused by the conditions stated by Section 87 TUIR: the divided rights are not securities bookable among financial assets and therefore not suitable for inclusion within the scope of the provision.

Participations in investment companies and in joint stock companies are not within the scope of Section 87 TUIR, as they are not participations in companies. Cash downs aren't included either, as this operation is not similar to a sale and therefore the proprietary right remains held by the seller.
Capital gains arising from the sale of securities in foreign companies are within the scope of application of Section 87, if the conditions stated by Section 44, subsection 2, Lit b) are met (see above).

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Holding period

The conditions required by Section 87 TUIR for the exemption of capital gains are: classification of the participation among financial assets in the balance sheet referred to the first year after the acquisition; uninterrupted possession for 12 months from the first day of the month in which the participations were bought. The criterion followed is the LIFO, as in case of partial sales, the most recent shares are considered sold first; fiscal residence of the participated company in a white list country or ruling as of Section 167 TUIR with positive response; effective business activity by the participated company.

As stated above, the holding period equal to 18 months is one of the conditions set by the legislator for the application of the Participation Exemption provision with respect to capital gains. The rationale of this provision is simple: the exemption provision according to the legislator should be made applicable only for participations bought for long term investments; this is confirmed by the conditions of permanent holding for at least 12 months and the inclusion among the financial assets in the participating company's accounts. Furthermore, it can be stated that the longer the holding period is, the higher the probability that the capital gains are linked to the goodwill accumulated by the company itself and not by hexogen factors. Another reason for the introduction of a holding period is dictated by anti-avoidance rules: under the existing rules it appears more difficult that a good belonging to the company and different from a participation can be conferred to a newco, which could then be sold under the exemption rules.
As stated above, the holding period is determined counting back 12 months from the first day of the month when the participation was sold. This of course corresponds to holding periods longer than the days corresponding to 12 months.
What is even more relevant is the determination of the correct date with respect to the sale, this for the computation of the holding period. In cases of participation bought by third parties, the relevant day is the one of the subscription of the respective contract.

In cases of shares obtained through operations with respect to the company's equity, the relevant dates are the following. Bond issues: the subscribed shares have independent relevant dates corresponding to the date of subscription;

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capital increase: the relevant date is the date of subscription; if the subscription occurs because of a call option, the relevant date is not the one of the strike, but the sale of the security being the cause of the right to call new shares. If the right to call was bought separately, the relevant date is the one of the strike.

As stated above, operations causing only temporary transfers as dealings for the account are not suitable to be considered within the scope of application of the rule. In case of corporate restructurings under fiscal neutrality, the relevant date has to be referred to the date before the operation.

Different groups of participations acquired in different times

Section 87, subsection 1, Lit a), TUIR states that, in order to determine whether the participations were held permanently for a period equal to 18 months, the shares last bought are considered to be sold first ("LIFO method"). As a consequence, every acquisition of participations in the same company forms a separate group with reference to the holding period: a company will have groups of shares referred to each single acquisition and with consequent different seniority with respect to the seniority of the shares. The aforementioned application of the LIFO method for the determination of the relevant category of shares in case of successive sales determines a situation in which, given an acquisition strategy with more than one date of share acquisitions, the seniority to observed is always the one of the last acquisition. The underlying purpose is clearly given by an anti–avoidance objective: the actual legislation does not permit speculation on small amounts of participations and later, after a positive performance, the purchase of a bigger package for direct resale, using the seniority of the first small portion of the acquired equity. It is a matter of fact[347] that, in a situation of all held participations respecting the holding period, the method to apply is not the LIFO method: the selling company can freely decide which participations to sell first.

[347] See Introductory notes to Legislative Decree N. 344/2003.

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Booking among financial assets

Section 87, subsection 1, lit b) states that participations have to be booked among the class of financial assets in the participating companies balance sheet describing the financial situation of the relevant year in which the participation was acquired. The emphasis is given to the circumstance that the relevant participations have to be classified among financial assets and that this happens in the first balance sheet following the acquisition. The classification among financial assets has to be made by the participating company's management; this classification does not depend on obligations connected with the participation or the nature of the participation itself: it is the management's choice to decide whether a certain investment in participation is economically destined to be durable. The provision ruling about the possibility of a classification among financial assets is very broad, as there is no limitation with respect to the nature of the financial instruments to be potentially included. This leads to the conclusion that we are in the presence of a rather lax condition in this respect, confirmed also by the circumstance that the reference is made to the balance sheet after closing of the same and not following its approbation by the board of shareholders. This last rule simplifies the provision and grants permanent establishments, which are not obliged to have their accounts confirmed by the shareholder, the possibility to fall within the scope of application of the Participation Exemption referred to capital gains.
The fact that the provision explicitly states that the relevant participations have to be included among the category of financial assets in the balance sheet describing the financial performance of the first year raises two types of questions as follows:

With respect to the first aspect, the legislator introduced a specific provision, Section 4, subsection 1, lit g) of Legislative Decree N. 344/2003, that states that the aforementioned condition of inclusion among financial assets is matched if the relevant participations were classified among financial assets in the balance sheet referred to the year 2002. For participations acquired during fiscal year 2003, the rule states that the relevant balance sheet for the inclusion among financial assets is the one referred to the year 2003. Those participations have in fact to be classified under the respective position in the balance sheet made up to December 31st of 2003. It is not relevant for the first

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case, if the inclusion of financial assets occurred already in the first year of holding.

With respect to reclassifications it would have been understandable if the legislator had demanded the relevant participations to remain booked among financial assets for the whole period between the moment of the first inclusion in the correct accounting class and the sale. However, the Ministry of Finance declared that, under the condition that the relevant participation was booked according to the aforementioned provision in the first balance sheet, later reclassifications are not relevant for the application of the rule. This means that a participation, booked among financial assets in the balance sheet referred to the first fiscal year of possession, will always match the conditions of Section 87, subsection 2, TUIR, whether it is classified at the moment of sale or not. Conversely, this means that a participation once booked in the working capital can never fall within the scope of application of Section 87, subsection 2. the fact that classifications with respect to participations were included in the category of potentially elusive practices as of Section 37bis, Decree by the President of the Republic, N.600, must be referred to with caution. This has the effect that these classifications will not be recognized without valid underlying economic reasons.

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Commercial activity as a requirement referred to the controlled company

Another condition to be met by the subsidiary company is the effective presence of a business activity.[348] Business activities for tax purposes are listed in Section 55 TUIR and are defined habitual but non-exclusive activities according to Section 2199 Civil Code. This condition must again be met in the three fiscal years preceding the sale of the participation. The purpose is to avoid elusive interpositions of companies not carrying forward business activity just in order to make the Participation Exemption provision applicable. This, of course, would not be coherent with the attempt by the legislator to avoid double taxation issues. An effective operability of a subsidiary company is considered proof for the realization of an own income.

d. The impact of the exemption in the taxation of profits

Simmetry between exempt gains and non-deductible losses

Among Participation Exemption provisions with respect to capital gains there is normally the introduction of a principle of symmetry between the exemption capital gains and the non-deductibility of capital losses. This, according to Section 4, lit c) of Law 80/2003, is the case for the new Italian Company Income Tax (IRES): down writings of participations without fiscal recognition meet the general exemption of capital gains. As stated before the fiscal derecognition of down writings linked to exempt participations is a necessary

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[348] Andrea Vasapolli and Guido Vasapolli, *Requisito della commercialità nella "participation exemption,"* 1 CORRIERE TRIBUTARIO 65, 68 (2006); Gianfranco Ferranti, *L'Agenzia delle entrate chiarisce il requisito della commercialità ai fini della pex.*, 37 CORRIERE TRIBUTARIO 2999, 3005 (2009); Cristiana Di Felice and Ezio Maria Simonelli, *La participation exemption e il pasticcio della commercialità*, 2 RIVISTA DEI DOTTORI COMMERCIALISTI 365, 374 (2005); Andrea Ricci and Dario Stevanato, *Participation exemption e requisito di "commercialità": attività immobiliari e "patrimonio" di raffronto*, 12 DIALOGHI DI DIRITTO TRIBUTARIO 1703, 1708 (2004); Ferranti Gianfranco, *Il periodo minimo di sussistenza del requisito della commercialità per la «participation exemption»,* 41 CORRIERE TRIBUTARIO 3207 , 3211 (2004); Gianfranco Ferranti, *Il requisito della commercialità per la «participation exemption»,* 36 CORRIERE TRIBUTARIO 2811, 2814 (2006).

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consequence of the Participation Exemption provision with respect to dividends. As the exemption of capital gains appears to be a necessary consequence of the exemption of dividends, the logical circle can be defined closed in this respect. It has to be stated at this stage that it is not empirically proven that the exemption of capital gains is a necessary consequence of the exemption for dividends. More precisely, there is no exact evidence that the realized capital gain corresponds to a fund of accumulated dividends, not distributed formerly, in the majority of cases. It could well be that there is prevalence of other factors in the determination of capital gains, such as the general economic situation and the discounted actual value of the provisional future performance.

Non-deductibility of capital losses and related expenses

The provisions regulating the fiscal treatment of expenses linked to exempt participations knows three different classes of expenses: accessory expenses which are directly imputable, intermediation expenses for the operation which have special taxes and directly linked expenses such as counselling of legal, fiscal and financial types, general inherent expenses, residual category.

Accessory expenses directly connected with the sale's operation

These expenses are considered deductible because they are explicitly mentioned by Section 87, subsection 1. These expenses are caused specifically with reference to the operation and cannot be avoided. The classic examples are special taxes for the presentation of documents and intermediation fees.

Accessory expenses directly imputable to the sale operation

Accessory expenses directly connected with the transaction are not deductible according to Section 4, subsection 1, lit e) N. 6 of Law N.80. The law demands a direct link to the transaction for these non-deductible expenses.

General inherent expenses

These expenses are represented by the portion of all general expenses referable to the participations of Section 87 TUIR. There is no provision openly expressing this rule, but Section 109, subsection 5 states that all general

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expenses are deductible, if referred to taxable profits. The general non deductibility provision of Section 96 TUIR prevails over this general deductibility provision. In fact Section 109 continues affirming that all expenses filtered by the general pro rata (general non-deductibility provision) as of Section 96 are deductible for the part, determined by the formula of Section 96, which is, in simple terms, a fraction dividing exempt income by taxable income resulting in a general ratio to be applied to certain expenses. With regard to exempt capital gains and dividends, Section 96 TUIR states that exempt capital gains and dividends are not included in the calculation of the general non-deductibility ratio. This has the effect that the portion of inherent expenses referred to income in the form of Section 87, is deductible.

Deductibility of expenses for entities subject to the Corporate Income Tax

Capital gains by the sale of stocks outside the scope of application of Section 87 TUIR is ruled by the following Section 85: taxable capital gains are profits deriving from the sale of shares and securities, even if the participation is not represented by securities, which are not financial assets and are outside the scope of application of Section 87. Section 44, subsection 2: states under which circumstances securities in foreign companies are considered stock.
Section 85, subsection 1 lit d): capital gains from the sale of securities in foreign companies similar to stock as stated by Section 44, subsection 2 are taxable, if not matching the conditions of Section 87; Section 85, subsection 1 lit e): profits from the sale of mass or series of securities and obligations generates ordinary income, although the exchange is not part of the typical activity of the company.

This aforementioned income is taxed according to the general rules with respect to corporate income. More precisely it is to be included in the company's taxable income. The detailed description of the rules with respect to those parts of general corporate income goes beyond the object of this analysis.

In cases of amounts received by the shareholder after the dissolution of the company, reduction of the capital and shareholder back down, Section 86, subsection 5bis states that the aforementioned payments, as of Section 47, subsection 5 and 7, represent capital gains with reference to the cash amounts

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or the fair market value of the goods received. Consequently, Section 87, subsection 6 states that the scope of the Participation Exemption rule includes capital gains according to Section 86, subsection 5bis.
With reference to the payments or goods received by the shareholder, it has to be pointed out that the amounts exceeding the recognised book value of the participation represent capital gains, while the amounts paid as dividends bear the ordinary taxation, according to Section 89 TUIR.

Participation exemption for capital gains and determination of the tax base in the personal income tax

Section 3, subsection 1, Letter c) N. 6 of Law N.80/2003 states that, given the partial taxability of capital gains, down writings and expenses with respect to the same participations shall be deductible in a symmetric way. This means that down writings and expenses linked to partially exempt participations as of Section 58, subsection 2, TUIR are deductible for 60 % of their amount according to the principle stated by Section 64 TUIR. With reference to down writings and expenses caused by participations which are held as investments by individuals, not carrying forward business activity, Section 68 TUIR rules that those expenses and losses are deductible at a rate equal to 60 % of their amount and that down writings and expenses have to be first deducted from other capital gains; in the case of a negative result of the aforementioned deduction, the difference can be carried forward for four years.

In case of individuals holding non-qualified participations as an investment, the same deduction has to be applied. If losses prevail with reference to all other different income, the negative difference can be carried forward and compensated with the future positive different income during the following four fiscal years.

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3. The Austrian approach: similarities and differences from the "participation exemption model"

a. The scope of application

Austria has a very individualistic approach to the tax treatment of capital gains from the disposal of shares. Many countries consider the exemption of dividends to go hand in hand with the exemption referred to capital gains but Austria breaks this link and continues to tax the gains resulting from the disposal of shares.[349]

This individualistic approach was accompanied by a series of measures, such as the option of full taxation versus the option for exemption, with consequent non-deductibility of the arising losses referred to the relevant participations that had the indisputable benefit of being very sensible for the real economic substance of the operations, but were always deemed to be to complex.[350]

From 1 October 2011, capital gains derived from the disposal of shares and units held in funds purchased after 31 December 2010 or bonds, debentures and derivatives purchased after 30 September 2011, that are business assets are subject to a special tax rate of 25%.

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[349] Taxation of Capital Gains in the European Union, Norway and Switzerland: An Empirical Survey with Recommendations for EU Harmonization and International Tax Planning, 37 Intertax 381, 404 (2009).
[350] MARTIN VOCK in GEROLD STOLL, WOLFGANG GASSNER, MICHAEL LANG, JOSEPH SCHUCH, KLAUS STARINGER (EDS.), SCHRIFTEN UND AKTUELLE BEITRÄGE ZUM ÖSTERREICHISCHEN ABGABENRECHT 41 (2008); HANS HASSLINGER in GEROLD STOLL, WOLFGANG GASSNER, MICHAEL LANG, JOSEPH SCHUCH, KLAUS STARINGER (EDS.), supra note 312, at 435; PETER DORALT, STEUERRECHT 2010/2011, 92 (2010); WERNER DORALT, DIE BESTEUERUNG DER KAPITALGESELLSCHAFT(1986).

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b. Structure of the exemption

Participating persons

Individuals resident in Austria for tax purposes do not have to tax capital gains from the disposal of shares under the Austrian participation exemption regime. This applies only for portfolio participation, i.e. participations not held in the course of an individual or corporate business. Two main exceptions exist to this general rule, however:

The first exception concerns the minimum holding period equal to 12 months which, if not respected and leading to a case where an individual sells non-business shares within 1 year after the purchase, the consequent income which will be defined as "gain from speculative transactions", will be treated as taxable income subject to progressive rates of up to 50 per cent.[351] The systematic consequence is that eventual losses from the disposal of non-business shares may set off against other gains from the disposal of other shares.

The second exception arises if the shareholder owns or has owned at any time during the preceding 5 years, directly or indirectly, a substantial shareholding, consisting of at least 1% of a company's share capital and then relevant participation is disposed, extraordinary income (section 31 öEStG) is realized which is taxable. at one half of the effective rate on the taxpayer's total income (section 37(4) öEStG).

If the shares do not have an historic purchase value because obtained by the shareholder in ways other than through money transfer, it is sufficient that the former owner held at least 1% of the company's share capital at any time during the preceding 5 years. The same participation can be set off against other capital gains from the sale of such participations but not against other income.

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[351] Section 30 öEStG.

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Following the German system and a general trend in final withholding taxes, given, for example, by the EU Savings Directive, Austria introduced a final withholding tax at a rate of 25% for realized capital gains from the disposal of shares, fund units, bonds and debentures offered to the public as well as secured derivatives with effect from 1st April 2012. This flat tax does not impose any other condition such as a minimum holding period or the holding of a certain percentage in the equity of the company whose shares are being disposed.

The new rule sets a special tax rate of 25% from operations arising after March 31st 2012. This is put in place through the regular tax assessment. The final withholding tax rate does not apply with reference to privately placed bonds and debentures, real property fund units or non-secured derivative financial instruments which continue to be taxed at the regular income tax rates.

With reference to the disposal of substantial shareholdings, which means that they represent at least 1% of the company's share capital at any time within the past 5 years, the respective capital gain is also subject to the final withholding tax at the rate of 25% with an additional consequence of non-deductibility of connected transaction costs.

Concerning participations held by an individual entrepreneur or a partnership, for both cases among their business assets, and in a resident company held as a business are subject to tax in any case, regardless of the holding period or the degree of holding.

These gains are taxed for 50 per cent of the effective rate on the taxpayer's total income.[352] Regarding substantial shareholdings (minimum holding of 1% in the last 5 years), the taxation at half of the progressive tax rate no longer applies for disposals after 31 March 2012. As said before, for capital gains realized from the sale of such assets after 31stMarch 2012, a special income tax at a rate of 25% applies.

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[352] Section 37, subsection 2 öEStG.

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Non-resident individuals are concerned by the taxation of capital gains only under the circumstance that the relevant gain refers to participations held through a permanent establishment in Austria.

This is not valid for gains for the disposal of substantial shareholdings in a resident company, as these are taxable anyhow whether attributable to a permanent establishment or not. It could be that the reduced tax rate stated above is applicable to those shareholders who are not resident.

Substantial corporate shareholders

Concerning the treatment of capital gains realized by Substantial corporate shareholders, it has to be stated that capital gains derived by a resident company from the disposal of business property, including shares in another resident company, are taxed as business income at the ordinary rate. No specific tax relief is provided for with reference to capital gains from the disposal of a participation in a resident company realized by a substantial corporate shareholder.

Capital gains of a non-resident company resulting from the disposal of shares in a resident company are subject to corporate income tax if they are produced through a permanent establishment situated in Austria.
Also these cases are treated as above and therefore subject to Corporate income tax at the normal rate.

A special case of international participation exemption applies for capital gains derived by a non-resident company having no permanent establishment in Austria: the disposal of shares in a resident company leads to a capital gain that is taxable only if participation is equal at least to 1 per cent at any time within the preceding 5 years.[353] Taxation is eliminated, however, in most cases under a tax treaty.

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[353] Section 21, subSection 1 öKStG in connection with section 98, subSection 1, number 8 öEStG, from 1 April 2012 section 98, subSection 1, number 5, letter e) öEStG.

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It is stated expressis verbis that costs incurred with reference to exempt participations are deductible.[354] This is of some importance as, if not stated openly, those kind of costs would be non-deductible according to the general rule of connection between exempt income leading to non-deductible, directly linked, cost.[355]

4. The Swiss variant of the EU-Tax model

a. Introduction

Rationale: coherence of the system

Before applying the tax reform of 2009, Switzerland did not use a system comparable to the Participation Model, already used in other European Countries. The first step had been to exempt dividends in participations equal to at least 20% of the equity of the company or cooperative or for participation representing a market value of at least CHF 2 million.

In fact, the Corporate Tax Reform of 1997 had developed this mechanism by covering also capital gains, under the condition that the gain resulting from a sale price higher than the purchase price was connected with a participation corresponding to at least 20% of the share capital of the subsidiary. The compulsory holding period was equal to one year.

To become more attractive for investments and to follow the European trend, Switzerland decided to lower the minimum participation threshold to 10% of the share capital and the minimum participation to 10%. The minimum value of the participation at fair value was consequently reduced to CHF 1 million. These easier rules were introduced by the tax reform of 2009.

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[354] Section 11, Subsec. 1, line 4, öKStG.
[355] PETER DORALT, STEUERRECHT 2010/2011, 111 (2010).

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An important aspect is that the new threshold applies to both capital gains and dividends.
The qualifying holding period for capital gains remains one year. If the portion of shares falls below 10% after reductions, the exemption for future capital gains will still be granted if the fair market value of the participation remains at least CHF 1 million.[356]

b. Sphere of application

Under the Swiss rule, capital gains are generally taxable by means of introduction into the income figure relevant for taxation. The relevant value to be taxed is given by the difference between accepted book value of the asset and the sale price realized.

Particular conditions have to be met if M&A transactions occur: in cases of a merger, division or transformation, the difference between accepted book values and price of realization are not included within the taxable income on the condition that the book values are not changed, the fiscal residence of the concerned entities remains in Switzerland and that no sale of the concerned assets occurs in the next 5 years or, alternatively, the responsible management of the companies remains unchanged.

Profits from the disposal of assets are not taxed when reinvested in Switzerland. The same is applicable if the replacement does not occur in the same financial period: an equivalent of the deferred profit can be formed as a reserve and written off within an appropriate period (usually 2 years); the alternative is to include the accumulated reserve within taxable income.

Reserves resulting from the disposal of qualified participation and the consequent deferral of taxation through amortization can be transferred from

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[356] Markus F.Huber and Lionel Noguera, *Second Corporate Tax Reform in Switzerland*, BULLETIN FOR INTERNATIONAL TAXATION 74 (2009).

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one entity to another if the concerned participation have been held for at least one year.

Participating persons

As stated above, dividends are generally taxable on the level of the shareholder. The participation exemption model in this country works as relief granted for certain categories of shareholders, whereas the possibilities of the controlled entity´s legal form are almost unlimited, making a list not useful. However, relief is granted with respect to a substantial participation in a resident or non-resident company (participation exemption).

Capital gains on substantial participations are included in the sphere of application of the Swiss participation regime, including gains on subscription rights in respect of such participations. Revaluation gains on substantial participations do not qualify for the participation exemption.

The participation exemption model as present does not allow any depreciation on, and valuation allowances for substantial participations. These amounts are consequently added back to taxable.

Similarly to the case of participation exemption with reference to the distribution of profits, to qualify for the exemption of capital gains, the conditions to be met are set forth as follows: a minimum participation in the relevant company of at least 10 per cent of the equity capital, a holding period equal to at least 12 months from the purchase and a gain realized with reference to the sale of at least 10 per cent of the equity capital, within the same tax period. Participations with a fair market value of at least CHF 1 million qualify for the participation exemption under particular conditions, when they are held for at least 1 year, even if the 10 per cent ownership requirement is not met.[357]

[357] Siegfried van Kommer, Switzerland - Federal Taxation - Corporate Taxation sec. 2, Country Surveys IBFD.

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Persons subject to the personal income

With reference to resident or non-resident individual shareholders, capital gains realized by the sale of shares in a Swiss resident company are normally tax free in Switzerland, unless the shares are part of the business assets of the shareholder or the activities of the shareholder do not qualify as private asset management but as professional stock broking (article 16 DBG).

The decision whether a sale of participations is to be considered as part of a private asset management or professional stock broking is judged on a case-by-case basis according to the following criteria: if there is a systematic approach to the trading of shares, in particular with strong efforts to realize gains by monitoring the market trends of stock exchanges, professional stock broking is deemed to have occurred. What is also relevant for the distinction is the frequency of transactions, the duration of the ownership, the closeness of the relationship between the trading and the taxpayer's business, and the use of outside capital or loans.

When a sale is deemed as part of stock broking, capital gains realized on the disposal of the securities are subject to individual income tax.
At the same time, individual income tax is levied on the disposing shareholder when a company purchases its own shares,[358] the assets of the purchased company are used to finance the sales price[359] or if the purchaser or the shareholder sell the shares to a company controlled by the same shareholder.[360]

Mergers and acquisitions, divisions and transformation operations are treated favourably by the possibility to not carry back hidden reserves into taxable income. This applies on the condition that the book values are kept unchanged, the entities involved remain taxable in Switzerland, the transferred assets are not sold within the following 5 years and the management of the entities involved remains unchanged.

[358] deemed partial liquidation; Section 20, subsection 1, letter c, DBG.
[359] Deemed indirect partial liquidation; Section 20a, subsection 1, letter c, DBG.
[360] Transponierung as provided for by Section 20a, subsection 1, letter d, DBG.

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In the case of replacement of qualified participations (at least 10%) the hidden reserves can be transferred to the new participation if the participation has been held for at least 1 year.

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CHAPTER V. COMPARATIVE ASPECTS

Coming to the description of the comparative aspects emerged in this thesis and the consequent analysis of a possible circulation of tax models, the observation of the coordination from a supra-national perspective can be perceived as a first approach to the issue.

The second step concerns the analysis of the degree of coordination achieved by means of the circulation of tax models among countries. This phenomenon is related to "policy learning":[361] The idea behind this concept is that many countries have followed fundamental tax reforms in the leading industrialized countries and adjusted their own systems accordingly.[362]

As mentioned in the first methodological paragraphs of this work, *tax mechanisms* referred to the tax systems discussed are analysed in respect to their *structural elements*. The results of that aforementioned work is then included in a comparative theory of the evolution of corporate tax models.[363]

According to the latest developments in the science of International Comparative Taxation,[364] a "tax problem" is "a tax matter needing to be dealt with" and therefore is a practical problem because the policy-maker, confronted with a tax problem, must decide a specific course of action using a set of rules. In this diagnostic approach, tax policy decisions concerning corporate taxes are solutions to tax problems.
Once it is clarified what is meant by tax problem, three different levels of evolutionary comparative analysis can be distinguished:

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[361] CARLO GARBARINO END PAOLO PANTEGHINI, CORPORATE TAXATION IN EUROPE: COMPETITIVE PRESSURE AND COOPERATIVE TARGETS IN GREG GREGORIOU (EDS.), INTERNATIONAL TAXATION HANDBOOK (2007).
[362] MARCO BARASSI, COMPARAZIONE GIURIDICA E STUDIO DEL DIRITTO TRIBUTARIO STRANIERO, in, VICTOR UCKMAR, DIRITTO TRIBUTARIO INTERNAZIONALE 1499 (2006).
[363] Carlo Garbarino, supra note 2, provides a detailed analysis of methodological issues applied here.
[364] GARBARINO CARLO END PANTEGHINI PAOLO, supra note 382.

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1) At the first level, there is a common core in corporate tax systems of EU countries in relation to basic *tax problems*.
2) At the second level, there is circulation of *tax models* among different EU countries.
3) At the third level, there is regulatory articulation of domestic corporate *tax mechanisms,* which are meant as a set of rules aiming to solve corporate tax problems.

The first level: basic tax problems

We can identify a core of several corporate tax problems that are common to EU countries, of which two were analysed in this work:

1) *tax treatment of corporate distributions*: each EU country has to decide how (and to what extent) to avoid double dividend taxation caused by the overlapping of personal and corporate income taxes.
2) *limitation on the deduction of interest expenses*: each EU country has to decide whether (and to what extent) interest payments and other financial costs can be deducted.

The second level: the emergence of tax models

The subsequent step to the above is the description of tax models adopted by the tax systems compared for the solution of the existing tax problems.
With respect to the tax treatment of corporate distributions these models are:

1) the classical system
2) the imputation system
3) reduced taxation of distributed profits;[365]
4) Participation Exemption, that provides zero or reduced taxation on dividends and/or gains from sales of qualified participations.

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[365] A good example of reduced taxation is provided by Germany's split-rate system according to which, until 2000, retained profits were taxed at 40% whereas dividends were taxed at 30%. This system was abandoned in 2001.

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With reference to the limitation to the deduction on interest the possible tax models are:

1) the fixed debt/equity ratio (or tax treatment of thin capitalization), which dTUIRtes that, if the debt/equity ratio exceeds a given ratio, the exceeding interest remuneration is deemed as constructive dividends. This has the effect that debtor cannot deduct interest paid on loans granted by qualified shareholders and/or related parties;
2) the re-characterization of interest as non-deductible expenses, according to which interest is re-characterized as non-deductible expenses in so far as the underlying financial source meets crucial requirements of equity rather than of debt;
3) the 'arm's length' approach, which entails the non-deductibility of interests paid between affiliated companies which is in excess of what would be paid between unconnected parties dealing at arm's length.
4) the assets dilution ratio, according to which certain expenses related to acquisition of participations generating non-taxable income (capital gains or dividend) are not deductible for the acquiring company, either by way of a ratio between taxable and non-taxable income or by a ratio between financial and non-financial assets.
5) the fixed EBITDA ratio. This means that, given the fact that all interest is covered, interest expenses higher than a certain percentage of the relevant profit are not deductible.

The third level: from tax models to domestic tax mechanisms

The *third level* of comparative analysis deals with the evolution of domestic corporate tax mechanisms in various EU countries.
Tax evolutions can appear in the form of:[366]

a) intra-system evolution;
b) EU inter-system transplant;
c) EU inter-system evolution.

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[366] GARBARINO CARLO END PANTEGHINI PAOLO, supra note 382.

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Intra-system evolution occurs when an element of a corporate tax mechanism is modified within a single country and such an element represents an innovation with respect to the former nature of that given tax mechanism.
Inter-system transplantation occurs if tax mechanism innovations in one legislation and already existing similar mechanisms in other legislations have an identical origin.
Inter-system evolution occurs when similar elements have a common function but not a common origin.
In the EU, corporate tax mechanisms do not change exclusively through domestic internal processes (intra-system evolution), but also through importation of tax mechanism elements (EU inter-system transplant) as well as legal innovations inspired by foreign tax mechanisms (EU inter-system evolution). In the latter two cases we therefore have the *circulation of models*. The outcomes of such a circulation can be summarized as follows:

a. full tax convergence,

b. partial tax convergence (divergence),

c. full tax divergence.

Full tax convergence means that generally adopted tax models prevail and generate very similar tax mechanisms, which do not have major differences from the initial tax model. This example applies to specific areas covered by EU tax Directives.

Partial tax convergence can occur at the level of either
(i) corporate tax mechanisms: although the models applied are similar, the embedded mechanisms compete because of specific national choices made by the respective legislator.
(ii) corporate tax models

Full tax divergence occurs mainly at the level of corporate tax models and entails the predominance of a given corporate tax model over all others.

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1. Erosion of the national tax base through the deduction of interest

Non deductibility provision for interest borne because of shareholder loans, exceeding a fix ratio				
	ITALY	GERMANY	AUSTRIA	SWITZERLAND
RELEVANT MODEL	Interest Barrier Rule	Interest Barrier Rule	Flexible criteria concerning equity	Re-defined flexible criteria concerning equity
WORKING OF THE RULE	Excluding smaller companies, fiscal units, interest payments summing to more than 30 percent of Ebitda are not deductible	Excluding smaller companies, groups of companies, interest payments summing to more than 30 percent of Ebitda are not deductible	Excluding smaller companies, groups of companies considerations on loans granted or guaranteed, directly or indirectly, by a qualified shareholder or its related parties is not deductible, if the debt/equity ratio exceeds a certain market value state by the tax administration	Excluding smaller companies, groups of companies considerations on loans granted or guaranteed, directly or indirectly, by a qualified shareholder or its related parties is not deductible, if the debt/equity ratio exceeds a certain ratio

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Non deductibility provision for interest borne because of shareholder loans, exceeding a fix ratio				
	ITALY	GERMANY	AUSTRIA	SWITZERLAND
RATIONALE	No permission of arbitrages resulting from the different tax treatment granted to profits and interest	No permission of arbitrages resulting from the different tax treatment granted to profits and interest	No permission of arbitrages resulting from the different tax treatment granted to profits and interest	No permission of arbitrages resulting from the different tax treatment granted to profits and interest

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a. Common elements

During this analysis, for this first part regarding the tax treatment of thin capitalization, it emerged that the countries observed presented basically two families of tax models: Italy and Germany on the one hand, countries which are adopting the so called EBITDA rule and, on the other hand, Switzerland and Austria, adopting a criterion similar to a debt:equity ratio, based on administrative principles. Obviously, the analysis of converging and diverging elements will focus on the comparison between the two which, in this respect, adopt the same model of taxation.

Seen initially, the German and Italian design of the tax model referring to an EBITDA rule are identical. Both countries adopt a similar base for calculation of the relevant profit, net interest and, by no accident, use the same non deductibility ratio. Austria has rather flexible rules within a fixed range of acceptable debt:equity ratios given by jurisprudence, while Switzerland´s tax administration determines open portions of debt deemed acceptable with reference to certain figures of the financed company´s costs and assets.

Nonetheless, deep divergences arise in the effective tax design adopted to implement the relevant rules. It is once more confirmed what was affirmed at the beginning: the study of the chosen tax system from a domestic point of view and the understanding of the respective legal formants present gives rise to a true analysis according to what was stated in respect of the theoretical framework of this discipline.

b. Diverging elements

Germany and Italy start by implementing the same tax model: the so called EBITDA rule for the determination of the non deductible portion of interest deductions. The two countries start from a similar thin capitalization provision which was definitively abolished by the introduction of the aforestated model. The relevant tax rule deriving from the implementation of the mechanism has, however, strong diverging elements. The Italian rule is designed with a very extensive but in fact superficial scope of application. There are very few

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clauses catching elements of thin capitalization which are formally under the relevant EBITDA margin but in substance follow intentions of avoidance, the relevant rule is simply stated and stays as it is. Any amount of interest below the relevant barrier is deemed deductible and that it is. Germany has a whole set of additional clauses limiting the deduction of interest formally below the relevant margin but contracted for the purpose of tax avoidance. What in this respect is extremely interesting is the circumstance that the German system uses parts of the formerly thin capitalization debt:equity ratio to recapture deductible interest as a first element and that Germany uses a completely different ratio, the group´s equity factor, to determine whether there is aggressive shareholder financing. Germany could, so to speak, be seen as adopting a rule based on the EBITDA rule but using elements of the Swiss and Austrian system on the one hand and the formerly applicable thin capitalization debt:equity ratio on the other.
It is relevant in this respect that the German rule is therefore to be put between endogenous models and international tax models.

Austria and Switzerland also use similar models as for their formal framework Both are based on a mixture of jurisprudence and administrative principles and both follow a typical substance over form arm´s length approach in determining the portion of debt acceptable for the purpose of interest deduction. The basis of the model is the consideration of the relevant equity which can be partially increased by debt deemed to be hidden equity under specific conditions. The relevant interest payments would consequently be deemed profit distributions and consequently not deductible. The main difference arises from the fact that Austria uses criteria subject to continuous interpretation by tax courts because of their lack in precision while Switzerland publishes simple portions of debt deemed acceptable with reference to certain assets and costs.

c. Circulation of the tax model

Problems relating to *limitations on the deduction of interest* have evolved over the last decade through EU inter-system legal transplants and therefore by circulation of the fixed debt/equity ratio model.[367] On the contrary, the models

[367] CARLO GARBARINO AND PAOLO PANTEGHINI, supra note 382.

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of re-characterization of interest as non-deductible expenses and asset dilution ratio have evolved nationally (intra-system evolution), with adjustments which have occurred either at a statutory level or administratively and/or as judicial guidelines.[368]
Both re-characterization of interest and the asset dilution ratio have developed by intra-system evolution leading to country-specific tax mechanisms, while the arm's length' approach has been introduced as a model thanks to OECD guidelines. On the contrary, the re-characterization and assets dilution approach is only marginally applied.

According to the descriptive chapters about the Italian Interest Barrier Rule, the formerly applicable tax model represented one element among a more complicated and *intricate host of provisions.*[369] The complex combination of three different deductibility ratios (general deductibility ratio referring to costs incurred versus exempt income, patrimonial deductibility ratio referring to cost borne for the realization of exempt income according to participation exemption, the thin capitalization ratio limiting interest expenses with respect to loans granted by qualified shareholders) had the effect of massively high compliance cost for the taxpayer and litigation cost for the tax administration.

The Italian government reacted appointing a special commission, the so called Biasco Commission, which had the goal of making proposals for a broad reform of corporate taxation and also to target some of the issues seen most critical in the Italian tax system. The final report was published in summer 2007.[370]

What is interesting in this respect is that in this occasion, where a commission formed of tax experts discussed various issues of a potential tax reform and interacted with the academic world, there are significant reports of the work

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[368] For example, in certain cases, deduction is limited by an explicit statutory ratio, while in other cases ad hoc guidelines determine whether interest is related to exempt income and therefore not being deductible.
[369] Giuseppe Galeano and Alan Rhode, *Italy Sets the Barrier to Deduction of Financing Costs at 30 per Cent of EBITDA*, INTERTAX 295 (2008); Tommaso di Tanno, *Prospettive di riforma dell'IRES: spunti di riflessione sulle prime indicazioni ricavabili dalla relazione della Commissione Biasco*, 5 DIRITTO E PRATICA TRIBUTARIA 893 (2007).
[370] *Commissione di Studio sulla imposizione fiscale sulle società – Relazione finale*, available at: www.governo.it/backoffice/allegati/35328-3951.pdf.

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put in place and the final result. Analysing the reports of the commission we can move directly to one of the most relevant aspects of International Comparative Taxation: the process in which the preparation for the selection of tax models is put in place, the discussion of their efficiency, the explained link between a certain tax problem and the search for determined tax solutions circulating through certain tax models. If we were to take the example of thin capitalization, we would be in a situation, from the Italian point of view, where a national tax rule derived from an international tax model[371] was deemed to be too complicated and not efficient.[372] The reaction of the legislator in this respect can theoretically be two-fold: either directly select a model circulation internationally or create an endogenous tax rule. Assuming that there are virtually infinite possibilities concerning the field between the two possibilities, the Italian legislator obtained a final report by the Biasco Commission which contained a tax model, a special form of the debt/equity ratio with progressive deductibility allowances.[373] The actual design proposed for that kind of tax rule could be defined as *Intra-system evolution,* as an element of a corporate tax mechanism was presently intended to be modified within a single country and this element represented an innovation with respect to the former nature of that given tax mechanism and also with respect to other models present on the international tax scene.

The government did not follow the advice of the Biasco Commission and introduced a classical Interest Barrier rule, based on the German example.
The final result showed the selection of a completely different model originating in the family of Interest Barrier Rules, so called Ebitda margins for purposes of interest deductibility. Interesting in this respect is the actual reasoning of the aforementioned commission in the process of advising the government: it was stated that the method advised by the commission itself would have been the best but that there were other European models in place which could have

[371] Law 7 aprile 2003, n. 80, Sec. 4, lett. G), Delega al Governo per la riforma del sistema fiscale statale; G.Pizzitolla, La capitalizzazione sottile tra la salvaguardia della tax jurisdiction domestica e discriminazione rispetto ai non residenti: profile comparatistici e domestici, Rass. trib. 2003, P.2159; FEDERICO TRUTALLI IN CARLO GARBARINO, ASPETTI INTERNAZIONALI DELLA RIFORMA FISCALE 258 (2003).
[372] Commissione di Studio sulla imposizione fiscale sulle società – Relazione finale, at 50.
[373] Commissione di Studio sulla imposizione fiscale sulle società – Relazione finale, at 60.

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been adopted by the legislator. The situation given could be characterized as "non successful trend-setting" as the advisers tried to push a model of an endogenous nature while being aware of the fact that international tax models would have been successful. We should therefore confirm what we said before about Competition among Tax Models[374] and the benchmarking process of the legislator who, being involved in limited knowledge, prefers to adapt international models of taxation than internally developed tax rules.[375]

In Germany where, before the tax reform of 2007, a similar rule to Italian, formerly applicable, thin capitalization provision was in place, similar critiques emerged.[376]

One important aspect should be added: while Thin Capitalization provisions had a clear anti-abusive purpose, the recently introduced interest barrier rules have the same purpose but are also seen as instruments of economic policy as they reduce any kind of recourse to debt.

There is full convergence with reference to the mechanisms put in place by both legislators although the underlying mechanisms present a different level of complexity. Austria and Switzerland follow the same arm´s length approach and converge on the observation of the relevant hidden equity cause by excessive shareholder financing.

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[374] Carlo Garbarino, *Tax Transplants and the Circulation of Corporate Tax Models*, in BRITISH TAX REVIEW 159 (2011).
[375] It should be quickly mentioned that the self-made version of a Thin Capitalization provision, the progressive Double Income Tax advised by the commission, technically speaking, would have been much more efficient and coherent to the rest of the tax system, see ADRIANO MODOLO IN BEGHIN MAURO (ED.), SAGGI SULLA RIFORMA DELL'IRES 79 (2008).
[376] See Modellrechnungen des Instituts der deutschen Wirtschaft Köln (IW) published under www.idw.de; Ralph Brügelmann and Winfried Fuest, Pressemitteilung des IDW, 26/28 Juni 2006.

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2. Distribution of profits

Exemption for dividends received by companies, partnerships and individuals				
	ITALY	GERMANY	AUSTRIA	SWITZERLAND
RELEVANT MODEL	Participation Exemption for dividends	Participation Exemption for dividends	Participation Exemption or dividends	Participation Exemption for dividends
WORKING OF THE rule	Exemption equal to 95% of dividends received by resident companies or permanent establishments of non resident companies. Partial exemption for dividends received by partnerships or individuals.	Exemption equal to 100% of dividends received by resident companies or permanent establishments of non resident companies. Partial exemption for dividends received by partnerships or individuals.	Exemption equal to 100% of dividends received by resident companies or permanent establishments of non resident companies. Partial exemption for dividends received by partnerships or individuals.	Exemption equal to 95% of dividends received by resident companies or permanent establishments. Partial exemption for dividends received by partnerships or individuals. Conditions to be met: minimum participation and value of the participation
RATIONALE	Simplification/ Modernization of tax system. Elimination of forms of discrimination with respect to foreign shareholders	Simplification/ Modernization of tax system. Elimination of forms of discrimination for foreign shareholders	Simplification/ Modernization of tax system. Elimination of forms of discrimination for foreign shareholders	Simplification/ Modernization of tax system. Elimination of forms of discrimination for foreign shareholders

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a. Common elements

The treatment of dividends under the Italian, German, Austrian Participation Exemption method presents many converging elements. With reference to the sphere of application of the provisions in both legislations, it has to be mentioned that there is a complete identity. In both systems, the provision is valid for resident shareholders and non-resident shareholders, having installed a permanent establishment in the respective country. The absence of specific conditions to be met by the participations themselves for making the Participation Exemption applicable is a further converging point. German administrative rules present a specific way of putting in place the so-called type comparison in order to analyze whether a foreign form of company could be identified by one of the existing types of company existing in the German legislation. The included types of profit distributions follow a *substance over form approach*, as in both countries any distribution arising under whatever title is included in the sphere of application of the Participation Exemption system.

The stated condition that profits must have the quality of non deductibility from the tax base of the distributing person is another common element present in both tax systems. With reference to the taxable portion of the distributed profit, both legislators introduce a taxation equal to 5% of the relevant profit in case of distributions occurring between companies and a taxation of 49,72% in Italy and 60% in Germany, in the case of profits distributed to partnerships and individual entrepreneurs. Italy still presents some specific rules for the taxation of profits received by private investors. Provisions referred to companies resident in tax havens are of different nature, as Germany basically accepts profit distributions from companies resident in those legislations, except for cases of interposed companies, and Italy applies a general taxability, unless a ruling with a positive result is obtained before the relevant date of the distribution.
An elimination of the taxability equal to 5% of the received profit in cases of fiscal consolidation, exists in both countries.

Austria adopts a very similar model for exemption of dividends. Switzerland sets conditions to be met and renders the profits exempt by a certain general pro-rata ratio.

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b. Diverging elements

It has to be stated that there are no strong diverging elements in the model itself, unless stated by specific links to rules outside the model itself, as for example CFC – rules, taxation of private investors and definition of companies for tax purposes. Switzerland sets certain conditions for the application of the exemption. These conditions are based on the percentage of participation and the fair value of the participation held.

c. Circulation of the tax model

It can be stated that the two analyzed tax systems followed a process of inter-system legal transplants (and therefore circulation of models), put in place within the EU - countries.
Currently EU-15 countries (except Spain and the U.K. that still adopt the imputation system) adopt:

1. the classical system (in an unmodified or modified form) for individual and portfolio corporate shareholders, generally providing "rough and ready" relief of double taxation;
2. Participation Exemption for corporate shareholders.

In respect to dividend taxation and to the Italian and the German tax system, there is full tax convergence at least for those issued covered by Directive 435/90, that has implemented the Participation Exemption model only for intra-group qualified corporate distributions.

These respective tax reforms are the joint result of top-down pressure and of bottom-down circulation of models. On the one hand, in *Saint-Gobain ZN*, case C-307/97, 21st September 1999, the ECJ declared that Germany's full imputation system was discriminatory as it granted a tax credit to resident shareholders only, thereby placing a restriction on the free movement of capital within the EU. This ruling, as well as subsequent ones regarding other member

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states, forced Germany and other countries to switch to partial exemption.[377] On the other hand, the treatment of shareholding has been overshadowed by the treatment of the income of the underlying companies. This phenomenon is related to the increased number of foreign shareholders. In such a context full imputation is very demanding from an informational point of view and, thus, less manageable.

Some authors explain the introduction of the Participation Exemption in Italy as a necessary alignment measure with reference to the most efficient European tax systems.[378]

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[377] In order to prevent revenue losses, none of these countries decided to extend full imputation to non-resident shareholders.

[378] Giuseppe Tesauro, *Aspetti internazionali della riforma fiscale*, FISCALITÀ INTERNAZIONALE 427 (2003).

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3. Exemption of gains from the disposal of shares

Exemption for capital gains on the alienation of shares				
	ITALY	GERMANY	AUSTRIA	SWITZERLAND
RELEVANT MODEL	Participation Exemption for capital gains	Participation Exemption for capital gains	Ordinary taxation of capital gains	Participation Exemption for capital gains
WORKING OF THE rule	Exemption equal to 95% of the capital gain realized. Following conditions must be met: • holding period • classifications of the shares as financial assets • participation in a white list country • participated company with commercial activity Capital losses on the aforementioned shares will not be deductible	Exemption equal to 95% of a capital gain realized on an alienation of shares in companies, without additional conditions to be met. Capital losses on the aforementioned shares will not be deductible	Full taxation of capital gains at the ordinary Corporate tax rate	Exemption equal to 100% of a capital gain realized on an alienation of shares in companies, provided that the following conditions are met: • minimum participation • minimum book value of the participation • holding period
RATIONALE	Simplification/ Modernization of tax	Simplification/ Modernization of tax		Simplification/ Modernization of

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	system. Elimination of forms of discrimination with respect to foreign shareholders	system. Elimination of forms of discrimination with respect to foreign shareholders		tax system. Elimination of forms of discrimination with respect to foreign shareholders

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a. Common elements

The tax treatment of capital gains within the global Participation Exemption method represents many converging elements, such as the identification of the personal sphere of application referred to the Italian and the German tax system. It has to be stated that the mechanisms are similar, but present peculiarities with reference to the objective sphere of application. While the German legislator seems to consider a perfect identity of profit distributions and capital gains realized with respect to participations in identical persons, the Italian legislator states stricter rules concerning both the conditions to be met by the participations falling within the scope of the Participation Exemption for capital gains and the taxability of the arising capital gains. Capital gains realized by a German resident company by means of the sale of a participation in another company are exempt for 95% of its amount. The corresponding Italian gain is exempt for the same amount of the received gain. The Italian tax system is also stricter with reference to the deductibility of costs linked to the exempt participation, allowing deductions only for non-avoidable costs arisen by the sale and the relevant part of general costs. The German provision, stating deductibility for all costs directly linked to the participation in an economic sense, is certainly broader.

There are again differences arising because of the treatment of Italian private investors and different rules concerning persons resident in tax havens.

Switzerland adopts a slightly different model while Austria does not accept the logical link between the exemption of dividends and capital gains and taxes relevant capital gains.

b. Diverging elements

As stated above, divergences can be observed particularly with reference to the level of taxation of capital gains realized by companies and the conditions to be met by the respective participation, such as a holding period, residence in white list countries, effective conduct of commercial business activity by the participated company and booking among fixed financial assets.

Germany adopts an exemption of capital gains without demanding for any specific conditions to be met such as Italy and Switzerland while Austria taxes capital gains at the ordinary tax rate applicable for corporations.

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c. Circulation of the tax model

It was mentioned before that a “tax problem” is “a *tax* matter needing to be dealt with” and therefore a *practical problem*, because the policy-maker, confronted with a tax problem, must decide a specific course of action using a set of rules. In this diagnostic approach, tax policy decisions concerning corporate taxes are solutions to tax problems.[379]
Now it appears clear in this circumstance that both the German and the Italian Participation Exemption have the aim of dealing with the same tax problem: the taxation of capital gains realized by companies and partnerships within the sphere of application of a Participation Exemption system. It appears that the aforementioned circumstance, that the rationale underlying a Participation Exemption system states irrelevance with respect to the fact that reserves are distributed by profit distributions or by sales and realizations of capital gains, is followed in a more coherent way by the German legislator. Concluding, it can be affirmed that, although there are relevant differences concerning the tax mechanisms, the tax problem to be solved by the Italian and the German Participation Exemption provision concerning dividends is identical. It can be stated that the same tax model is present in both legislations. The same is applicable to Switzerland while Austria positions itself inside a different family of tax models.

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[379] CARLO GARBARINO AND PAOLO M. PANTEGHINI, CORPORATE TAXATION IN EUROPE: COMPETITIVE PRESSURE AND COOPERATIVE TARGETS in GREG N. GREGORIOU AND COLIN READ C. (EDS.), INTERNATIONAL TAXATION HANDBOOK 9 (2007).

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
1.) Personal sphere of application			
Shareholders			
Section 89, subsection 2 and Section 73, subsection 1 TUIR resident companies: Companies, LLC's, limitedly liable partnerships organized in shares, cooperative companies, mutual insurance companies, private and public companies, different from companies, who carry on an effective conduct of trade and business non-resident companies: if the profits are booked for tax purposes in their Italian permanent establishment	Section 8b, subsection 1, dKSTG. resident companies: Companies, LLC's, limitedly liable partnerships organized in shares, cooperative companies, mutual insurance companies non-resident companies: concerning domestic income under the condition that they meet the requirements of a so called type comparison and are consequently considered similar to one of the types of companies existing in Germany.	Section 1, subsection 1 and 3 letter a) öKStG. resident companies Stock companies (AG), limited liability companies (GmbH), private foundations, commercial enterprises operated by public entities, associations, institutions, foundations without independent legal existence and accumulations of property for a specific purpose non-resident companies: concerning income realized in Germany under the condition that they meet the requirements of a so called type comparison (*se supra*) and are consequently considered similar to one of the types of companies existing in Austria.	Section 49, subsection 1 DB. resident companies Legal entities subject to corporate income tax include stock companies (AG); limited liability companies (GmbH); private foundations; commercial enterprises operated by public entities; associations, institutions, foundations without independent legal existence and accumulations of property for a specific purpose non-resident companies: concerning domestic income under the condition that they meet the requirements of a so called type comparison and are consequently considered similar to one of the types of companies existing in Switzerland

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
2.) Requirements and objective sphere of application			
Specific conditions			
Section 89, subsection 2 and Section 73 TUIR No specific conditions with reference to: • minimum participation in the equity of the participated person • holding period • booking among financial fixed assets • minimum taxation of the participated person • legal title of possession • residence of the participated company in a white list country	Section 8b, subsection 1 dKSTG No specific conditions with reference to: • minimum participation in the equity of the participated person • holding period • booking among financial fixed assets • minimum taxation of the participated person • legal title of possession • residence of the participated company in a white list country	Section 10, subsection 1 öKSTG No specific conditions with reference to: • minimum participation in the equity of the participated person • holding period • booking among financial fixed assets • minimum taxation of the participated person • legal title of possession	Section 69 and 70 DB To qualify, the conditions are: • minimum 10% capital holding • holding period equal to 1 year • at least 10% of the capital in the company must be sold. • participations of at least CHF 1 million (held for at least 1 year) qualify under particular conditions for the participation exemption, even if the 10% ownership requirement is not met

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Distribution of profits			
Section 49, 59 and 81 TUIR Distribution under any title and with any denomination	Section 8b, subsection 1 dKStG: All hidden and open profit distributions	Section 8b, subsection 2 öKStG: All hidden and open profit distributions	Section 58, subsection 1, letter b), DB: All hidden and open profit distributions
Requirements concerning shares held in the participated person			
Section 44, subsection 2, lit a) TUIR remuneration consisting totally in a profit participation of the company the shares are hold in, in other companies being part of the same economic group and referred to the specific business the shares were emitted for	Section 20, subsection 1, N. 1), 2), 9), 10) dEStG the payment will be considered a dividend, if the respective payment is linked with the receiving person's right to participate in the profits of the distributing person	Section 27, subsection 1, N. 1 öEStG the payment will be considered a dividend, if the respective payment is linked with the receiving person's right to participate in the profits of the distributing person	Section 620 OR the payment will be considered a dividend, if the respective payment is linked with the receiving person's right to participate in the profits of the distributing person
Partnerships as shareholders			
Section 47 dEStG Reduction to 60 % of the received dividend amount referred to the inclusion in the tax base	Section 23 subsection. 1 dEStG if distributed, the profit grants from a standard exemption rate on the level of the personal shareholder, equal to 50% of the net	Section 95, subsection 1 and Section 93 öEStG Final withholding tax equal to 25% of the gross dividend	Section 20, subsectiontiont 1 and 1bis DB if distributed, the profit grants from a standard exemption rate on the level of the personal shareholder

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
	profit amount received		holding the participation in his business assets, equal to 50% of the net profit amount received under the condition that the participation equals at least 10% of the shares
Participated companies resident in tax havens			
Section 47, subsection 4, TUIR Profits distributed by black list – resident companies do not fall within the scope of application of the Participation Exemption, unless a positive prior ruling is obtained According to Section 167, subsection 5, lit b)	Section 7-14 AStG Case of profit distributed by the company resident in a tax haven was formerly of German origin. In these cases profits, distributed to such interposed tax haven – resident companies, which are held by controlling (i.e. shareholding of more than 50%) individuals resident in Germany, cause the transparence of the corporate shield and make the relevant profits taxable as if directly received by the ultimate - German resident shareholder in Germany	Section 10, subsection 5 öKStG Investment income taxable if deductible for payer Only clause referred to purely artificial tax designs switch-over clause	Anti-Abuse Decree of 14 December 1962 Only clause referred to purely artificial tax designs old reserves theory anti-avoidance through use of double tax treaties

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Private investors			
Section 67, subsection 1, lett. c) – bis, Section 47, subsection 1, Section 27, DPR 600/1973 TUIR Qualified participations: Taxation of 40% of the received profit Section 67, subsection 1, lett. c) – bis, Section 47, subsection 1, Section 27 DPR 600/1973 Non qualified participations: Taxation at a flat rate equal to 12,5%	Section 23 subsection. 1 dEStG If distributed, the profit grants from a standard exemption rate on the level of the personal shareholder, equal to 50% of the net profit amount received Same treatment for dividends of foreign source	§ 93 Abs. 2 Z 3 and Abs. 3 and Section 97 öEStG Dividends received from a resident company are taxable as business income or as income from capital. A final withholding tax at a rate of 25% applies in both cases Same treatment for dividends of foreign source	Section 20, subsections 1 and 1bis Qualified participations: Taxation of 60% of the received profit if distributed, the profit grants from a standard exemption rate on the level of the personal shareholder holding the participation in his business assets, equal to 60% of the net profit amount received under the condition that the participation equals at least 10% of the shares
Same treatment for dividends of foreign source			
Entrepreneurs			
Section 59 and Section 47 TUIR Taxation of 60% of the	Section 23 subsection. 1 dEStG if distributed, the profit grants from a standard	§ 93 Section 2 Z 3 and Section 3 and Section 97 öEStG	§ 69 Abs. DB Dividends received from a

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
received profit Same treatment for dividends of foreign source	exemption rate on the level of the personal shareholder, equal to 50% of the net profit amount received Same treatment for dividends of foreign source	Dividends received from a resident company are taxable as business income or as income from capital. A final withholding tax at a rate of 25% applies in both cases Same treatment for dividends of foreign source	resident company are exempt up to 50% of their amount. Same treatment for dividends of foreign source
Companies as shareholders			
Section 89, subsection 2 and Section 73, subsection 1, lett. a) and b) TUIR Dividends of resident source Exclusion from the participating company's tax base of 95 percent of the received dividend (condition: foreign dividends are not deductible from the tax base of the distributing company)	Section 8b, subsection 1 öKSTG and Section 20, subsection 1, N. 1), 2), 9), 10) dEStG Dividends of resident source Exclusion from the participating company's tax base of 95 percent of the received dividend	Section 10, subsection 2 öKSTG and Section 27, subsection 3, N. 1, öEStG Dividends of resident source Full exclusion from the participating company's tax base	§ 69 Abs. DB Dividends of resident source Exclusion from the participating company's tax base of 95 percent of the received dividend If corresponding to • a participation in profits or shares equal to at least 10% • a fair value of the participation equl to at least 1 mn CHF

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Profits distributed by non resident companies			
Section 89, subsection 2 and Section 73, subsection 1, lett. a) and b) TUIR Same treatment unless residence in tax havens, which causes full taxability, if no preliminary ruling has been put in place	Section 8b, subsection 1 dKSTG and Section 20, subsection 1, N. 1), 2), 9), 10) dEStG Same treatment unless residence in tax havens with significantly lower tax rates.	Section 10, subsection 1 öKSTG and Section 27, subsection 3, N. 1, öEStG Same treatment unless residence in tax havens with significantly lower tax rates.	Section 69 DB Same treatment unless residence in tax havens with purely artificial conditions.
Profits distributed by companies within a consolidation for tax purposes			
Section 89, subsection 2; Section 73, subsection 1, lett. a) and b); Section 122, subsection 1, Lett. a); Section 134, subsection 1, Lett. a) TUIR Exemption equal to 100% of the received dividend in case of option for fiscal consolidation	Section 8b, subsection 1 dKSTG and Section 20, subsection 1, N. 1), 2), 9), 10) dEStG – D, Section 15 No. 2 dEStG Final effect of *Organschaft*: total exemption with reference to dividends distributed by consolidated subsidiaries	Section 9, öKStG Exemption equal to 100% of the received dividend in case of option for fiscal consolidation	No rules concerning fiscal units

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Costs linked to exempt profits			
Section 109, subsection 5 TUIR Full deductibility of costs linked to the management of participations	Section 8b, subsection 5 dKSTG Full deductibility of costs linked to the management of participations	Section 10, subsection 1 öKSTG and Section 27, subsection 3, N. 1, öEStG Costs connected to exempt participations are not deductible	Section 70 DB • full deductibility if proven; • lump sum of 5% considered automatically; • financing costs entirely deductible;
THE EXEMPTION OF GAINS FROM THE DISPOSAL OF SHARES			
Personal sphere of application			
Shareholder			
Section 87, subsection 2 and Section 73, subsection 1 TUIR • resident companies: Companies, LLC's, limitedly liable partnerships organized in shares, cooperative companies, mutual insurance companies, private and public companies, different from	Section 8b, subsection 1 dKSTG • resident companies: Companies, LLC's, limitedly liable partnerships organized in shares, cooperative companies, mutual insurance companies	Section 1, subsection 1 and 3 letter a) öKStG • resident companies Stock companies (AG), limited liability companies (GmbH), private foundations, commercial enterprises operated by public entities, associations, institutions,	Section 49, subsection 1 DB • resident companies Legal entities subject to corporate income tax include stock companies (AG); limited liability companies (GmbH); private foundations; commercial enterprises

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
companies, who carry on an effective conduct of trade and business • non-resident companies: if the profits are booked for tax purposes in their Italian permanent establishment	 • non-resident companies under the condition that they meet the requirements of a so called type comparison (*se supra*) and are consequently considered similar to one of the types of companies existing in Germany	foundations without independent legal existence and accumulations of property for a specific purpose • non-resident companies: concerning income realized in Germany under the condition that they meet the requirements of a so called type comparison (*se supra*) and are consequently considered similar to one of the types of companies existing in Austria	operated by public entities; associations, institutions, foundations without independent legal existence and accumulations of property for a specific purpose • non-resident companies: concerning domestic income under the condition that they meet the requirements of a so called type comparison and are consequently considered similar to one of the types of companies existing in Switzerland
Participated person			
Section 87, subsection 2 TUIR Resident and non resident companies with reference to the holding of the following types of participations:	Section 20, subsection 1, DEStG Resident and non resident companies with reference to the holding of the following participations:	Section 1 Section 10, subsection 1, ÖEStG Resident and non resident companies with reference to the holding of the following types of participations:	Section 49, subsection 1 DB Resident and non resident companies with reference to the holding of the following types of participations:

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
• Shares in companies of every kind, including those in limitedly liable partnerships organized in shares; • Shares in LLC's • Participations in cooperatives • Participations in other companies having the rights of a company • Participations in companies different from companies, resident in Italy, carrying on prevalently business activity • Participations in public or private companies, different from companies	• Genussrechte, embedding the right to receive profits and liquidation surpluses of a company; • Shares in LLC's, if deemed to be in a company • Participations in cooperatives • Participations in other companies having the rights of a company • Payments according to Section 16 Company Income Tax Act. These are payments made by a company consolidated for tax purposes due with respect to shareholders not participating in the consolidation; Gains realized by the sale of a foreign company after having attested the so called type comparison	• Shares in companies of every kind, including those in limitedly liable partnerships organized in shares; • Shares in LLC's • Participations in other companies having the rights of a company • Restitutions from the companies listed above • Other participation rights • Participations in non-resident companies	• Shares in companies of every kind, including those in limitedly liable partnerships organized in shares • Shares in LLC's • Participations in other companies having the rights of a company • Other participation rights; • Participations in non resident companies
Partnerships as shareholders			
Section 47 TUIR Reduction to 40 % of the	Section 23 subsection. 1 dEStG The capital gain grants from	Section 10 subsection 2 and Section 1, ÖKStG Capital gains on shares in a	Section 18b If realized in the course of

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
received capital gain referred to the inclusion in the tax base	a standard exemption rate on the level of the personal shareholder, equal to 50% of the net profit amount received	resident company are included in taxable income. Losses on shares may be deducted, but only if the taxpayer proves that the losses are not related to (open or hidden) profit distributions. If there is no such relation, the losses may generally be deducted pro rata over a period of 7 years.	business, and under the conditions that • the participation in profits or shares is equal to at least 10% of the total • the holding period equals 1 year The realized capital gain is taxed for 50% of its amount
Participated companies resident in tax havens			
Section 68, subsection 4, TUIR Capital gains realized by the sale of participations in black list – resident companies do not fall within the scope of application of the Participation Exemption, unless a positive prior ruling is obtained According to Section 167, subsection 5, lit b)	Section 7-14 AStG States particular conditions only, if the profit realized by the sale of a participation in an company resident in a tax haven was formerly of German origin. In these cases gains referred to the sale of participations in such interposed tax haven – resident companies, which are held by controlling (i.e. shareholding of more than 50%) individuals resident in	Not applicable	Anti-Abuse Decree of 14 December 1962 Only clause referred to purely artificial tax designs old reserves theory anti-avoidance through use of double tax treaties No CFC-rules

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
	Germany, cause the transparence of the corporate shield and make the relevant capital gains taxable as if directly realized by the ultimate - German resident shareholder in Germany.		
Private investors			
Section 68, subsection 3, Section 47, subsection 1, Section 27, DPR 600/1973 TUIR Qualified participations: Taxation of 40% of the received profit Non qualified participations:	Section 23 subsection. 1; section 17, subsection 1, dEStG Qualified participations: The gain grants from a standard exemption rate on the level of the personal shareholder, equal to 40% of the net capital gain received Non qualified participations:	Section § 93 Section 2 Z 3 and Section 3 and Section 97 öEStG Qualified participations Dividends received from a resident company are taxable as business income or as income from capital. A final withholding tax at a rate of 25% applies in both cases Non qualified participations:	Section 18b Qualified participations If realized in the course of business, and under the conditions that • the participation in profits or shares is equal to at least 10% of the total • the holding period equals 1 year the realized capital gain is taxed for 50% of its amount Non qualified participations:

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Section 68, subsection 1, lett. c) – bis, Section 47, subsection 1, Section 5, subsection 2, D.LGS 461/1997 DPR 600/1973 EStG Taxation at a flat rate equal to 12,5% Same treatment for dividends of foreign source	A taxable gain on the sale of a substantive share occurs if the individual sells shares of a company in which he directly or indirectly held 1% or more of the issued share capital at any time during the immediately preceding five years Same treatment for dividends of foreign source	A taxable gain on the sale of a substantive share occurs if the individual sells shares of a company in which he directly or indirectly held 1% or more of the issued share capital at any time during the immediately preceding 12 months. Same treatment for dividends of foreign source	Taxation at the ordinary rate
Entrepreneurs			
Section 58, subsection 2 and Section 60 TUIR Taxation of 60% of the received capital gain	Section 23 subsection. 1 dEStG The gain grants from a standard exemption rate on the level of the personal shareholder, equal to 60% of the net capital gain amount realized	Section § 93 Section 2 Z 3 and Section 3 and Section 97 öEStG Qualified participations Dividends received from a resident company are taxable as business income or as income from capital. A final withholding tax at a rate of 25% applies in both cases	Section 18b Qualified participations If realized in the course of business, and under the conditions that • the participation in profits or shares is equal to at least 10% of the total • the holding period equals 1

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
		Non qualified participations: A taxable gain on the sale of a substantive share occurs if the individual sells shares of a company in which he directly or indirectly held 1% or more of the issued share capital at any time during the immediately preceding 12 months.	year The realized capital gain is taxed for 50% of its amount Non qualified participations: taxation at the ordinary rate
Companies as shareholders			
Section 87 and Section 73, subsection 1, lett. a) and b) TUIR Capital gains of resident source Exclusion from the participating company's tax base of 95 percent of the received capital gain Objective sphere of application	Section 8b, subsection 1 dKSTG and Section 20, subsection 1, N. 1), 2), 9), 10) dEStG Dividends of resident source Exclusion from the participating company's tax base of 95 percent of the received dividend	Section § 93 Section 2 Z 3 and Section 3 and Section 97 öEStG Capital gains, not connected with a trade or business, derived from the disposal of shares and units held in funds purchased after 31 December 2010 or bonds, debentures and derivatives purchased after 30 September 2011, that are business assets are subject to a special tax rate of 25%	Section 69, subsection 1 and Section 70, subsection 4 DBG Within the same tax period, at least 10% of the capital in the company must be sold. Participations of at least CHF 1 million (held for at least 1 year) qualify under particular conditions for the participation exemption, even if the 10% ownership requirement is not met;

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Holding period			
Section 87, subsection 1, Lett. a) TUIR Uninterrupted possession for 18 month from the first day of the month in which the participations were bought. The criterion followed is the LIFO, as in case of partial sales, the most recent shares are considered sold first;	No minimum holding period required	No minimum holding period required	To qualify for the participation exemption, the minimum 10% capital holding must be held for at least 1 year;
Booking among fix assets			
Section 87, subsection 1, Lett. b) TUIR Classification of the participation among fix financial assets in the balance sheet referred to the first year after the acquisition;	Not required	Section § 93 Section 2 Z 3 and Section 3 and Section 97 öEStG Classification of the participation among fix financial assets in the balance sheet.	Not required
Residence of the participated person			
Section 87, subsection 1, Lett. c) and Section 167, TUIR	No specific conditions	No specific conditions	No specific conditions

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Fiscal residence of the participated company in a white list country or ruling as of Section 167, TUIR with positive response			
Effective commercial activity carried out by the participated person	No specific conditions	No specific conditions	No specific conditions
Section 87, subsection 1, Lett. d), TUIR Effective business activity by the participated company			
Deductibility of capital losses			
Companies Section 87, Section 101, subsection 1, Section 86, subsection 1, Lett. a), b), c), TUIR Capital losses not relevant for tax purposes	Companies Section 8b (3) dKSTG reductions in profits from the down writings of the shares named in subsection 2 to their lower fair market value or from the disposal of those shares or following the dissolution of the company or reduction of the share capital are not to be taken up into	Companies Section 12, subsection 2 and Section 97 öEStG Losses on shares may be deducted, but only if the taxpayer proves that the losses are not related to (open or hidden) profit distributions.	Companies Section 70, Para. 4, lit. a DFTL Holding companies Losses on shares may be deducted, but only if the taxpayer proves that the losses are not related to (open or hidden) profit distributions.

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Partnerships and individuals Section 64, Section 58, TUIR Capital losses relevant for 40% of their amount	the computation of income Partnerships and individuals Section 3c, subsection 2 Capital losses relevant for 50% of their amount	Partnerships and individuals Section 27(8) öEStG): - income from investment that is subject to the special income tax rate of 25%, pursuant to section 27a(1) of the {EStG), may not be set off against current income and income from realized increases in value of assets generating income from investment (e.g. private loans or private placements of securities); and - losses from investments that cannot be set off otherwise may not be set off against other categories of income.	The adjustment of the value and depreciation booked on an interest of at least 10% are added to the taxable profit to the extent that they are no longer justified (Section 62, Para. 4 DFTL) and provided that the offset of the depreciation is justified on a long-term basis

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DISTRIBUTION OF PROFITS			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
Deductibility of costs			
Section 87, subsection 1, Section 4, subsection 1, lit e) N. 6 of Law N.80, Section 109, subsection 5 TUIR • General inherent expenses → deductible • Accessory expenses directly imputable to the sale operation → not deductible • Accessory expenses directly connected with the sale's operation → deductible	Section 8b, subsectio 3, Sentence 1 dKStG full deductibility of the expenses sustained in connection with exempt participations. 5% of the capital taxed as legal fiction of non deductible costs	full deductibility of the transaction expenses sustained in connection with exempt participations	Section 58, subsectiontion 1, letter b DB no deductibility of the expenses sustained in connection with exempt participations.

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
1. Subjective scope of application:			
Included entities Section 96 TUIR and Section 73 TUIR All entities subject to corporate income tax, which are: • domestic limited companies and limited partnerships with shares, limited liability companies, cooperatives and mutual insurance companies, consortia; • public and private organizations, other from companies, resident trusts that carry out mainly commercial activities; not resident companies and entities, including trusts, that are legal persons or not, only with reference to the commercial activities carried out through permanent establishments in Italy.	Included entities Section 4h, subsection 1 dEStG; administrative guidance 4th July 2008, n° 2 – 10 All the entities holding a business are included: • stock corporations (limited liability companies, limited partnerships with share capital, limited companies); • partnerships (limited partnerships, unlimited partnerships, ordinary partnerships); • companies partially subject to taxation, as real estate companies; • sole traders; • public and no-profit trading companies; not resident companies that have a permanent establishment in Germany	Section 1, subsection 1 and 3 letter a) öKStG (Austria) Stock companies (AG), limited liability companies (GmbH), private foundations, commercial enterprises operated by public entities, associations, institutions, foundations without independent legal existence and accumulations of property for a specific purpose.	Section 49, subsection 1 DB Legal entities subject to corporate income tax include stock companies (AG); limited liability companies (GmbH); private foundations; commercial enterprises operated by public entities; associations, institutions, foundations without independent legal existence and accumulations of property for a specific purpose. Section 65 Zinsen auf verdecktem Eigenkapital Zum steuerbaren Gewinn der Kapitalgesellschaften und Genossenschaften gehören auch die Schuldzinsen, die auf jenen Teil des Fremdkapitals entfallen, dem wirtschaftlich

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
			die Bedeutung von Eigenkapital zukommt.
1b. Excluded entities:			
Expressly excluded entities: • consortia set up for unitary, partial or total, execution of works, pursuant to Section 96 of the regulation provided by DPR No. 554/1999 • project companies established in accordance to Section 156 of the Code of Public Contracts relative to Works, Services and Supplies, provided by D. Lgs. No. 163/2006 • companies established for the realization and carrying out of freight terminals pursuant to Law No. 240/1990 and further modifications companies whose share capital is mainly subscribed by public entities with particular activities.	Expressly excluded entities, as they do not constitute a business: • asset management partnerships • branches	All entities are included	All entities are included

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
2. Objective sphere of application:			
Section 96, subsection 3 TUIR; administrative guidance No. 19/E/2009, n° 2.2. All interest expenditures and profits and assimilated charges and revenues caused by loan contracts, financial lease contracts, bonds or similar securities and from every other contract with financial elements. Expressly included interest revenues: • implicit interest relative to trade payables; • virtual interest relative to credits towards public administrations. Expressly included interest payments: portion of implicit interest that results from lease contracts Exclusions Openly excluded interest	Section 4h, subsection 3, 2 dEStG; administrative guidance 4th July 2008, n° 15 – 26. Interest expenditures: compensations paid in exchange of debt financing that has reduced taxable income. Included interest profits: returns deriving from capital increases of whatever kind, that have increased the taxable income. Exclusions Openly excluded interest	Interest with respect to shareholder loans and related parties. All the interest expenses and revenues and all the assimilated charges and revenues that derive from loan contracts, financial lease contracts, issue of bonds or similar sectionurities and from every other contract that has a financial reason. Treated as hidden profit distribution/contribution: • loans made to shareholders either free of interest or at an unreasonable low rate of interest	All the interest expenses and revenues and all the assimilated charges and revenues that derive from loan contracts, financial lease contracts, issue of bonds or similar sectionurities and from every other contract that has a financial reason. Section 65. Interest on hidden capital comprehend that interest referred to debt fort he portion deemed equity.

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
expenses: • implicit interest that derives from trade debts • interest directly referred to the purchase or manufacturing cost of tangible and intangible business-operating assets • interest relative to loans taken out for the construction or redecoration of real estate, if company core business • interest included in the cost of inventories, other than real estates	expenses: • discounts • reimbursements transferred to reserves • refunds related to insurance contributions capitalized	• loans which are given with the intention that they will not be repaid • loans from shareholders at an unreasonable high rate of interest • leases to or from shareholders on unusual or unreasonable terms;	
3. Basic rule:			
Section 96, I, TUIR Net interest expenses are deductible up to 30% of EBITDA Relevant EBITDA: difference	Section 4h, I dEStG Net interest expenses are deductible up to 30% of fiscal EBITDA. Fiscal EBITDA: taxable	öKSTG 12 (1) iVm 20 Abs 1 und 8 Abs 2; VwGH, 28 April 1999, 97/13/0068, ÖStZB 1999/610 and VwGH, 14 Bundesabgaben-ordnung, (BAO) (KStG)	Section 65 DB Interest concerning hidden equity Is considered taxable. The significance ist hat that part of debt which is no longer

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
between production value and production costs, decreased by depreciation, amortization as well as financial lease payments	income decreased by interest revenues and increased by interest expenses, amortization and depreciation. Partnerships: Taxable income is determined modifying the figure "profit" on the basis of tax rules. Corporations: The same applies to the figure "income" on the basis of fiscal rules, for corporations.	Interest expenses for shareholder loans are deductible only if transaction is substantially and formally at arm´s length considering the debt:equity ratio usually applied in the relevant industry General interest expenses are deductible only in consideration of a certain minimum equity with respect to certain categories of assets and consequently a maximum amount of allowed debt.	considere debt but equity has a remuneration that is not deductible and therefore forms a part oft he profit.
4. Possibility to carry forward unused interest expenses:			
Section 96, IV, TUIR interest expenses can be carried forward to following financial years without any time limit. Not utilized EBITDA can be carried forward to the	Section 4h, I, 2 dEStG Entities are allowed to carry forward interest expenses to the following financial years without any time limit.	öKSTG 12 (1) iVm 20 Abs 1 und 8 Abs 2; Hidden equity remuneration considered dividend contribution and therefore not to be carried forward	

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
following financial years as well (starting from 2010).			
5. Provided possibilities to avoid the application of the rules:			
	Section 4h, II, 1 a, b, c dEStG Three escape clauses: • free limit of 1 Million €; • *Stand-alone Clause*: if the entity is not affiliated to any group; *Escape Clause*: if the entity proves that its ratio of equity over total balance sheet assets is not lower than 1% compared to the overall ratio of the group.	Not applicable	Not applicable
6. Bans for escape clauses			
	Section 8a, subsection 2 dKStG and Section 4h, subsection 2, 2 dEStG The entity cannot make use of the *Stand-alone Clause* if more than 10% of net interest expenses are paid to	Not applicable	Not applicable

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
	a substantial shareholder (more than 25% in the capital of the entity), to a person closely related to it or to a third with a right of recourse against the substantial shareholder or against the closely related person. The entity cannot make use of the *Escape Clause* if the entity or a group member pays more than 10% of its net interest expenses to a substantial shareholder, to a person closely related to it or to a third with a right of recourse against the substantial shareholder or against the closely related person, but only if such interest expenses are reported in the group consolidated financial statements or in case of a back-to-back financing with recourse of the third person against a shareholder or a related person who is not		

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LIMITATIONS CONCERNING THE DEDUCTION OF INTEREST			
ITALY	GERMANY	AUSTRIA	SWITZERLAND
	affiliated to the group		
7. Group tax consolidation:			
Section 96, subsection 3, TUIR Members of fiscal units are entitled to transfer excess Ebitda and interest portions to the holder of the group tax consolidation. Foreign companies included to the purposes of the provided rules.	Section. 15, I, 3 dKStG Fiscal units considered as unitary business, rules are applied on the level of the controlling entity.	Not applicable	Not applicable

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