

Part One

Trends in the Taxation of Capital Gains on Shares under Domestic Law

Chapter 1

General Report

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1.1. Introduction: Economic analysis of the tax treatment of capital gains

Since its inception, the tax treatment of capital gains has been heavily influenced by economic theory and, in respect of capital gains on shares realized either by individuals or by corporations, by the effects of such taxation on the stock market.

Since the creation of the income tax, two concepts of income have been opposed to each other. For the source theory, income is equalized with receipts drawn for a permanent source. Capital gains are therefore excluded from income. For others (e.g. theory of Haig-Simons) income is the net increase of the economic power of an individual between two points in time: it includes not only periodical income, but also the change in value of the stock of property rights between the beginning and the end of the tax period.

This discussion is further complicated by taking into consideration double taxation. If we limit ourselves to company shares, their acquisition is normally realized by means of savings, i.e. of income that has already been taxed when earned or otherwise realized. For theoreticians of the consumption tax (Meade), the amounts earmarked for savings and kept in savings accounts should be tax exempt.

On the other hand, as concerns shares of companies, the capital gain is generally the reflection either of reserves existing in the company the shares of which are sold or of the capitalization of future income that will be distributed under the form of dividends and will be taxed at the moment of distribution. One may observe, however, that particularly on the occasion of takeover bids, the capital gain may exceed the elements so defined, inter

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alia, by reason of synergies which will be found between companies or of other related elements, for instance the increase of market shares or the sheer ambition of executives or shareholders.

Insofar as capital gains on bonds are concerned, they will often be related to a decrease in interest rates.

If one defines a capital gain as the gain realized on a capital asset, one must ascertain that a capital asset is acquired in order to draw an income therefrom. Its value is in principle the present value of the future income expected during its existence, discounted by a capitalization rate equal to the interest of the market plus a risk premium. Risk premiums may be valued in a different way by different investors. This gives rise to speculative gains. In fact, the speculator is the one who foresees changes in value, arising essentially from the valuation of the risk premium.

On the other hand, a simple decrease of the interest rate carries on a value increase of future goods in relation to present goods by influencing the capitalization rate. However, a decrease of the interest rate is generally associated with a decrease of economic activity. The decrease of discounted income therefore goes in the opposite direction of the increase of the value of goods that could result from the lowering of interest rates.

The capital gains tax exists under various forms and is levied at various rates in numerous countries. The United States was the first country to introduce it. It undoubtedly has effects on the market economy. The first consequence is a locked-in effect. If gains are taxable and losses deductible, the owners of capital assets will tend to keep appreciated property and to liquidate depreciated property or, at best, to try and compensate losses and gains. The temptation of realizing losses on depreciated assets gives rise to a forced-out effect or mobilization effect.

The locked-in or immobilization effect is the partial consequence of another character of the tax: the bunching or concentration effect. Indeed, the tax bears in 1 year on a gain that represents the income of several years during which the property has gradually increased in value. In the case of a progressive tax, taxation will be higher than if it had taken place each year. The idea therefore arose to tax capital gains at reduced rates; this is accompanied by the idea to defer the tax if the amount resulting from the sale of a capital asset is reinvested (“rollover”).

The taxation of capital gains therefore has a destabilizing effect on the market: it increases fluctuations in price and in quantity, causing the prices to rise in a period of prosperity and to decrease in a period of depression by reason of the deductibility of losses. It therefore adds to cyclical instability.

However, the vendor considers the alternative use of his capital. If the return on another capital asset sufficiently exceeds the return that he expects from its present investment, he sees a benefit in realizing a sale despite the taxation of the gain. The tax, however, will produce a capital effect: the vendor who realizes a gain and is taxed will come back into the market only with an amount decreased by the tax, which will moderate the price rise. In a period of lowering prices, the capital effect of the deduction of losses will also moderate the decline of prices. The distinction as to tax rates between short-term and long-term gains is generally justified by a relief of the bunching effect. The longer the duration of possession, the stronger the bunching effect justifying a decrease of the tax rate upon realization of the gain. However, the system also creates a tendency to wait in order to enjoy the application of the long-term rate.

Finally, one must take into consideration the monetary portion of the gain due to inflation. This implies a revaluation of the purchase price for the computation of the gain. Such a system is often initiated when the taxation of capital gains is introduced in a country. This was the case in the United Kingdom. When the taxation of capital gains was introduced, the value of quoted securities for the future computation of gains was determined upon the entry into force of the statute (1965). For other assets, the computation of the gain was effected *prorata temporis* supposing that the gain was created in a uniform way during the holding period of the asset. However, the taxpayer could elect a computation of the gain by reference to the market value of the asset at the date of the introduction of the regime. The same system applied in Canada and in Ireland.

The choice of a system therefore depends on the locked-in effect, which is considered tolerable, measured in terms of an increase of the alternative return necessary to neutralize it in a period of depression. If one wants to favour investment in capital assets to stimulate growth, the law will exempt capital gains either totally or under condition of reinvestment. If the protection of the resources of the Treasury is essential, the deductibility of capital losses will be limited. The tax regime of gains and losses in capital appears therefore as an essential tool of modern economic policy. This explains the frequent changes of this regime, among others, in the United States. One has ascertained for instance that when the gains realized upon a sale against

cash were taxed whereas gains realized upon an exchange of shares during a takeover bid were not, the shareholders would require a higher premium if the price was paid in cash rather than if it was paid in shares.

To this, one must add that in most European countries, following the entry into force of the Parent-Subsidiary Directive generalizing the exemption of dividends paid by a company to another under certain conditions,³ capital gains on shares realized by companies were exempted as intercompany dividends were, although the directive did not mandate this. In this context, nothing prevents an investor or a group of investors to create a portfolio company, securing thereby the exemption of capital gains, accepting of course the non-deductibility of capital losses.

The last great change that occurred in the United States results from the law of 2003, Jobs and Growth Tax Relief Reconciliation Act, which reduced the tax rate on dividends for individuals from 38.6% (maximum) to 15% and reduced the tax rate of capital gains of individuals from 20% to 15%, although recent legislation increases both rates to 20% for high-income taxpayers. It seems that, following this legislation, the share of profits distributed as dividends by companies increased.

The debate is old. The late US President John F. Kennedy in his message to Congress accompanying the Tax Reduction Act of 1963 said that:

The present treatment of capital gains and losses is inequitable and constitutes a barrier to economic growth. The taxation of capital gains affects directly the investment decisions, the mobility and the flow of risk capital. The taxation of capital gains influences the passage from static situations to more dynamic situations, the ease of difficulty of new initiatives to obtain capital as well as the strength and potential growth of the economy.

Senator Connie Mack, Chairman of the Joint Economic Committee, was clearer in his 1999 report, *To decrease that tax rate on capital gains: The good policy for the 21st century*: “The most important character of the taxes on capital gains is their negative effect on efficiency and economic growth.”

3. Council Directive 90/435/EEC of 23 July 1990 (recast in Council Directive 2011/96/EU of 30 November 2011) applies to companies that (i) take one of the forms listed in the Directive, (ii) are considered to be resident in a Member State for tax purposes according to the tax laws of that State, and (iii) are subject to one of the taxes listed in the Directive. For the purposes of the Directive, the status of parent company is attributed to those companies holding a minimum of 10% (originally 25%) in the capital of the company distributing profits.

Alan Greenspan, the longest-serving Chairman of the Board of Governors of the Federal Reserve (1987-2006), once declared while testifying before the Banking Committee of the US Senate: “The most appropriate tax rate on capital gains is zero.”

1.2. Meaning of “capital gains on shares” under domestic non-tax law

Non-tax law provides little guidance as to the notion of capital gain. Accounting rules may be relevant to capital gains or losses. In the United States, equity securities will be accounted for under the consolidation method if the parent controls the subsidiary and under the equity method if the parent holds a significant non-controlling interest, the investment being recorded at cost and increased or decreased by a share of the income or loss of the subsidiary.

Smaller investments are recorded at cost. If a market value is available, a distinction is made between trading securities, for which unrealized gain or loss must be reported as non-operating income, and available for sale securities, for which it must be reported as other comprehensive income (OCI), without an influence on earnings per share. If such securities are “impaired” on a more than temporary basis, a loss must be recorded.

Those rules draw no distinction between ordinary income and capital gains and have no influence on the tax treatment of gains or losses on shares.

Under accounting rules implemented in the European Union by the fourth company law directive on company accounts,⁴ financial fixed assets may be revalued or a reduction value must be booked on the basis of the profitability of the company in which shares are held. In countries where the tax treatment is tied to the accounting treatment, tax rules will be needed to disregard those entries in the tax computation.

Capital gains are defined under Italian accounting law as the difference between the consideration received and the value of shares in the accounts. They will be recorded as ordinary or extraordinary income based on whether

4. Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 (1978).

or not they are produced by ordinary activity. In addition, shares must be booked as financial fixed assets or trading investments and this will determine the tax treatment of gains.

1.3. Meaning of “capital gains on shares” under domestic tax law

1.3.1. Definition of capital gains on shares

The definition of a capital gain under US tax law is a model of clarity. A capital gain is a gain from the “sale or exchange” of a “capital asset” and is short term or long term depending on its holding period. Contrary to some tax regimes (e.g. Belgium), disposal will not include involuntary conversion. Capital assets are defined by exclusion of assets specifically listed, such as inventory.

Assets used in a trade or business are excluded because their treatment is more favourable to the taxpayer: if the year results in a net gain, it is treated as a capital gain; if it results in a net loss, ordinary income regime applies.

Under the Anglo-Saxon tradition, the metaphor of the fruit and the tree led to the taxation of periodic income, but not on the profit realized when disposing of the asset that was the source of the income. Capital gains have therefore been taxed at a later stage (United Kingdom, 1965; Canada, 1972; Australia, 1985).

Gains realized on the disposal of shares held in the carrying-on of a business of investing for profit or trading in shares will be considered as ordinary income, whereas the gain on shares held as “capital assets”⁵ or “capital property”⁶ will benefit of a favourable capital gain treatment. The case law will often refer, in the poetic view of pioneers, to the concept of an “adventure or concern in the nature of trade” as the criterion of the distinction.

Liquidation

The liquidation of a company the shares of which are held by other companies raises two problems:

5. Australia.

6. Canada, section 54 (capital property) of the Income Tax Act (R.S.C., 1985, c. 1 (5th Supp.)) (ITA).

- (1) Will the difference between the fair market value of the assets of the liquidated company and their accounting value be taxable to the liquidated company?
- (2) Will the corporate shareholders be taxed as if they had realized a capital gain or as if they had received a dividend?

In the United States, which follows the capital gain approach, the liquidating company is taxed and the corporate shareholders acquire the assets at fair market value. An exception is provided in favour of the liquidation of a subsidiary in the hands of its 80% parent: the liquidation is tax free to both companies and the parent takes the tax basis of the subsidiary in the assets transferred. This rule will not apply to a cross-border outbound liquidation.

Some countries adopt a mixed approach. The corporate shareholder that is not a trader realizes a capital gain to the extent that the distribution exceeds the cost base of the shares, but a dividend to the extent of a distribution representing assessable income of the liquidated company (Australia). In other countries, only the capital can be returned tax free; the excess is treated as a dividend (Canada).⁷

Business reorganizations

Business reorganizations involve two types of capital gains: one to shareholders and one to the corporation itself. In the United States, mergers, demergers, contributions to capital and share exchanges can generally be accomplished in a tax-deferred manner (section 368 of the Internal Revenue Code (IRC)). Contributions in exchange for stock are tax exempt when the transferor controls the transferee after the exchange.

Share exchanges are generally tax exempt if the acquirer has an 80% control on vote or value of the subsidiary within 12 months.

A new provision enables the purchaser of shares of a target to be treated as if it had acquired the assets and to create in the assets a tax basis equal to their fair market value. The seller is treated as selling shares and realizing a capital gain or loss whereas the purchaser must pay the tax that the seller would have paid on any gain created by the deemed asset sale (section 338 of the IRC). If the reorganization takes place in a cross-border context, tax-free

7. Id. subsecs. 84(2) and 88(2). An exception applies where the shareholder is a Canadian parent corporation that owns at least 90% of the shares of the subsidiary, in which case the winding-up may occur on a tax-deferred basis (subsection 88(1)).

treatment will be granted in some cases with a corresponding reduction in the basis of the shares for the computation of future capital gains (section 367 of the IRC). The section 338 election is attractive since the foreign company involved will not be subject to capital gains tax in the United States.

Entirely foreign reorganizations are generally without tax consequences in the United States, except in the case of controlled foreign corporations (CFFs).

In China, domestic reorganizations entail capital gains tax. Some exceptions are provided for cross-border reorganizations.

We refer to the specific report on reorganizations for further analysis (*see* chapter 6 of this volume).

1.3.2. Income tax treatment of capital gains on shares

1.3.2.1. Participation exemption regimes

Are dividends and capital gains subject to the same tax regime?

In most countries, dividends and capital gains are subject to the same regime (e.g. Germany, Sweden and the Netherlands) and in particular they are eligible for the participation exemption, which relies in both instances on the intent to avoid double economic taxation of income.⁸ In other countries, the exemption on gains applies also to dividends, although conditions may differ. In Belgium, for instance, dividend exemption requires a minimum holding (10%), which is also the case for Luxembourg, which requires a minimum acquisition cost of EUR 6 million compared to the EUR 1.2 million required for dividends.⁹ The taxable base may also be different. In Belgium, for instance, dividends are limitedly exempted to 95% of the distributed amount to reflect expenses relating to the participation while capital gains are entirely exempt.¹⁰ This discrepancy also applies in Norway.

8. This is only partially true for capital gains that may also reflect the effect of inflation, future income or appreciation of assets so that in some countries the application of the participation exemption to gains and its rationale have been discussed and sometimes criticized.

9. The minimum cost of acquisition is an alternative to the minimum holding of 10%, which applies to both dividends and capital gains.

10. The rationale of this discrepancy may be found in the circumstance that the gains reflect an extraordinary item of income so that a lump-sum deductibility of costs based on the amount of the gain may prove to be arbitrary (*see* below in this section).

Few countries (China, Japan) provide for a participation exemption regime only in respect of dividends, while subjecting capital gains to ordinary taxation.

Is the participation exemption the most appropriate method to eliminate double taxation on capital gains on shares?

The participation exemption is widely used within the EU and EEA Member States and has become more widely adopted after the repeal of the imputation system, under which elimination of double taxation was eliminated on dividends through a dividend tax credit mechanism – which was then found contrary to EU law if not made available to non-resident shareholders. Indeed, Italy adopted the participation exemption both for dividends and gains in 2003 after the repeal of the imputation system. Other countries have also moved from the imputation system to the exemption system, namely Germany (2001), France (2004) and Finland (2005). It is worth noting that in all such countries the move from imputation to exemption was parallel to the move from taxation to exemption on capital gains. Sweden adopted exemption on dividends in 2000 and moved from taxation to exemption of capital gains shortly after in 2003.

Several domestic systems have shown a convergence of the tax regimes of both dividends and capital gains, which might suggest a review of the allocation of taxing rights under the OECD Model for which reference is made to chapter III at articles 10 (Dividends) and 13 (Capital gains). The move to exemption has also been experienced in other countries that previously applied other methods to eliminate economic double taxation, such as the RISK method (*Regulering av Inngangsverdi med Skattlagt Kapital*) in Norway under which the cost basis of shares was increased by the amount of retained earnings of the investee company. This mechanism, which was abolished in Norway in 2006, was discussed also in other countries (Italy) but it was found to present difficulties of application; particularly, some profits of the investee company may be subject to deferred taxation so that it would be difficult to keep track of when the corporate tax actually applies and correspondingly increase the tax cost of the shares for the corporate shareholder. In addition, if the investee company is not a resident of the state of the corporate shareholder, there might be difficulties to document the taxation of the profits in the foreign state provided that the rule of the increase of the tax cost of the shares for an amount equal to the taxed profits of the investee company should also apply to foreign companies to avoid exposure to EU criticism.

In Australia, capital gains on foreign non-portfolio holdings are reduced by the active foreign business asset percentage of the foreign company at the time of disposal. The mechanism amounts to a reduction of the taxable gain and it may be wondered whether it conceptually falls within the family of participation exemption regimes. The exemption of gains on foreign shares only – which may also be found in Austria – indeed does not rely on the circumstance that gains reflect retained earnings that were subject to tax on the investee company, in which case exemption would have applied also to gains on domestic holdings. The exemption perhaps has to do with an incentive to outbound investment.

Is the participation exemption regime subject to conditions? Is this desirable?

Most participation exemption regimes provide for conditions either regarding the entity whose shares are being disposed of and/or the corporate shareholder. In principle, these conditions try to cope with a variety of goals: (i) avoid application of the exemption when the gain reflects the ordinary trading course of the business of the corporate shareholder, (ii) avoid application of the exemption to transfer of enveloped passive assets, (iii) make sure the exempted gain is the result of an effectively taxed income and (iv) prevent abusive application of the exemption targeting the “exempted gain” characterization as opposed to other classes of income.

The variety of goals is unlikely to be pursued successfully and indeed literature and case law indicate a material level of interpretative uncertainty and undesirable effects of the regime. The complexity is echoed by the proliferation of requisites which are sometimes redundant. Review of domestic legislations indicates six different requirements in Finland, five in Italy, the Netherlands and Australia and four in Austria, France and Sweden.

Most conditions do not seem helpful for the following reasons.

Some domestic legislation¹¹ requires the shares to have been shown as *fixed assets* in the balance sheet of the corporate shareholder for accounting purposes, which in principle should document the non-trading nature of the holding.

However, accounting rules look at the intention of the shareholder so that the balance sheet representation is open to great discretion (under only a

11. Italy, France.

few circumstances is there evidence as to the short selling nature of the investment, as may be the case when by-laws of the shareholder include expressly short selling as the primary purpose of the company or when upon the acquisition the purchaser entered into a firm commitment with a third party to resell the shares). It is not a coincidence that most legislations providing for the accounting condition of the shares being entered as fixed asset also provide for anti-abuse rules that permit the tax authorities to disregard balance sheet representation.¹² The condition is therefore neither satisfactory for the revenue (the taxpayer has material discretion) nor for the taxpayer (who is exposed to uncertainty due to the application of anti-abuse rules and has no possibility to provide evidence of the non-trading nature of the holding irrespective of its classification in the balance sheet). Some countries (e.g. Finland) make the participation exemption subject to the fixed asset condition, which, however, does not rely on the balance sheet representation. The excessive level of discretion and the difficulty to rely on the balance sheet entry is confirmed by the provisions which in some countries (e.g. Italy) permit applying anti-abuse rules to the balance sheet entry and characterize differently the nature of the holding regardless of the representation made by the taxpayer. Perhaps the balance sheet entry could remain as a negative condition only, so that the entry as a trading asset would by itself prevent the availability of the exemption, but not vice versa.

Other countries (e.g. the Netherlands) focus also on the activities conducted by the corporate shareholder to establish whether or not the holding reflects a long-term investment, which is a more effective criterion compared to the entry of the shares in the balance sheet. This condition applies also in Finland, although it is viewed as a condition separate and distinct from that of the long-term investment intention. The activity of the investee company is also relevant as it is viewed as a continuation of the activity of the corporate shareholder. Pointing to the corporate shareholder requires factual review, which may be less friendly to non-resident taxpayers and also to the tax authorities of the source country, which factor must be considered in drafting model legislation (the Netherlands have mitigated the issue through a generous interpretation of the condition, especially when the taxpayer is a foreign intermediate holding company). Documenting purpose and actual conduct of the business to benefit from exemption may indeed obstruct business transactions and increase the level of compliance and accordingly make audit and assessment more difficult to be administered.

12. In Italy, under the general anti-avoidance rule (article 37-*bis* of Presidential Decree 29 September 1973, 600) the tax authorities may deny the regime applicable to capital gains or losses on shares if the classification of those shares (as financial fixed assets or current assets) has been made solely for the purpose of achieving an undue tax advantage.

Another condition is the *minimum holding*, which is reflected either in absolute terms (e.g. Luxembourg, which requires a minimum acquisition cost of EUR 6 million) or as a percentage of voting rights or share capital owned by the corporate shareholder (5% of share capital in the Netherlands and 10% of share capital in Luxembourg or in Sweden solely for gains on listed companies). This condition wants in principle to reflect the non-trading nature of the holding on the assumption that a material investment or the holding of significant voting rights or capital expresses the long-term nature of the investment. Under some legislation the minimum threshold includes indirect holdings (the Netherlands) and the participation exemption continues to apply for 3 years following the lowering of the holding below the minimum to the extent that the shares have been held for at least 1 year. Interestingly, the law acknowledges that shares remain eligible for the participation exemption even after partial disposal, namely when the threshold is no longer met.¹³ The minimum holding also seems rather arbitrary and indeed the percentage of holding varies from country to country, which difference is not justified by the different tax systems.

Another condition is the *holding period* that may be found in Belgium, Finland, France, Luxembourg and Sweden (for listed investee companies only) and which may vary from 1 (Belgium and Luxembourg) to 2 years (France). In Belgium, the condition was included only recently following criticism on the loss of revenue resulting from the absence of any limitations. In principle, the condition should also ensure that shares have not been held for trading. However, there are arguments to conclude that the holding period condition might be avoided. Firstly, trading business could be dealt with by special provisions (e.g. Belgium, which, however, also maintains the holding period condition). In addition, situations exist in which the failure to meet the holding period condition does not reflect an abusive transaction and it is unreasonable that the corporate shareholder cannot rebut the presumption and obtain the participation exemption regime. The non-proportionality of the condition has been raised in the context of VAT grouping, but the European Court of Justice (ECJ) found the condition reasonable (it held that a 1-year holding period was not excessive).¹⁴ The concept of “stability” of the investment (as opposed to the intention to hold a participation for speculative purposes) is also referred to by the Fourth Council Directive

13. Art. 13(6) Corporate Income Tax Act 1969. The participation regime remains available for a period of 3 years.

14. IT: ECJ, 22 May 2008, Case C-162/07, *Ampliscientifica Srl, Amplifin SpA v. Ministero dell'Economia e delle Finanze, Agenzia delle Entrate*, ECJ Case Law IBFD.

on annual accounts,¹⁵ which defines “participating interests” as those holdings that were acquired in order to contribute, by creating a “durable link”, to the participated company’s activities. However, no minimum holding period is required and the existence of an intention to create a “durable link” is presumed for holdings above a certain thresholds (fixed by the Member States, which may not exceed 20%).¹⁶

It is therefore desirable not to include the condition or to make it subject to contrary evidence or to consider it as a safe harbour condition (meeting the holding period makes the shareholder eligible for the participation exemption, but not meeting the holding period does not automatically exclude the application of the exemption).

Another condition frequently adopted in participation exemption regimes is the *nature of the business of the investee company*, which ideally should prevent the application of the relief method to mere transfers of assets that are enveloped in a company without any business activity (e.g. gains on shares of passive real estate companies are excluded from exemption in Italy and Finland). However, the borderline between business and passive investment is sometimes difficult to draw in a legislative provision. This is shown by the variety of situations which might fall under a restrictive interpretation and be unduly denied the relief. In Italy, for instance, it is intensely debated whether preparatory activities meet the business test: the tax authorities’ position, according to which the active business test is not met until the activity described in the company’s statute has been effectively started,¹⁷ has been opposed by domestic tax courts, who gave relevance to preparatory works carried out by investee companies for the integration of the active business test.¹⁸

In some countries, the regime applies solely to taxable persons meeting certain *legal form requirements of the shareholder*. This is the case in Norway, which applies the requirement also to non-resident taxpayers that need to have a legal form which is similar to the domestic legal forms for which the

15. Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies, OJ L222/11 (1978).

16. Article 17: “For the purposes of this Directive, ‘participating interest’ shall mean rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company’s activities. The holding of part of the capital of another company shall be presumed to constitute a participating interest where it exceeds a percentage fixed by the Member States which may not exceed 20 %.”

17. Parliamentary interrogation 5-01695 of 29 July 2009.

18. Provincial Tax Commission of Cagliari, 404 of 17 December 2010.

participation exemption applies (a similarity test for non-resident shareholders also applies in Sweden). In Finland, non-transparent partnerships are not eligible entities, although they are subject to corporate tax while gains on partnerships fall under the exemption in Sweden as from 2010. Also, private equity investors are excluded from the exemption regime regardless of the legal form they have adopted. This is due to the alleged nature of trading investment of their holdings, but this view is not shared by other countries that rely on the balance sheet representation which may permit private equity investors to show their holdings as fixed assets.

Capital gains on shares held in foreign resident companies are also eligible for the participation exemption (e.g. Norway) but under such circumstances *the foreign entity must not be subject to a low-tax regime*, otherwise the rationale of the participation exemption to avoid double taxation of income would be frustrated. In some countries, when such low-tax regime applies, the participation exemption remains available to the extent that the foreign entity meets a business test requirement (Netherlands; Norway, where the exemption applies if the low-tax country is also an EEA country). As mentioned earlier, the participation exemption in Australia is available solely on gains relating to non-resident holdings.

It is worth noting that the Primarolo Report listing the domestic tax rules which may represent harmful tax competition included participation exemption regimes that exempt the gain and permit the deduction of capital losses arising on the same holdings.¹⁹ A recommendation not to grant exemption to gains on shares when the investee company is subject to a low-tax regime was included in the OECD Harmful Tax Competition Report of 1998.

The participation exemption regimes may therefore include legislations which establish no conditions (Germany only excludes banks and financial intermediaries) and others which require either minimum threshold and/or holding period and/or business activity test. It is worth noting that Germany and France which belong to these two different systems and that Germany in the Green Book, which the two countries have published on a common

19. The list included the following regimes that have been subsequently amended in the respective countries: the 1929 company's regime in Luxembourg, the Dutch participation exemption regime, the Gibraltar tax regime laid down by the Gibraltar 1992 Companies, the Austrian regime, the Danish regime and the Austrian tax exemption regime.

tax basis to be adopted in the future considers – for dividends – following the French approach and including a minimum holding as one condition for the exemption.²⁰ This trend may be equally followed for capital gains.

In conclusion, a model participation exemption regime should grant relief subject to the sole condition that the profits of the investee company have been subject to corporate tax. Special rules should be applied to trading companies. In this respect, the minimum holding should be used as a safe harbour only so that a company engaged in trading of shares could also be eligible for the participation exemption on shares that have been held for a minimum period.

The above-mentioned model legislation is adopted by the EU Commission’s CCCTB proposal,²¹ which applies the exemption (article 11(d) of the Proposal) but indeed requires the investee company not to be subject to a low-tax regime (article 73 of the Proposal) and denies the exemption to trading assets and liabilities (article 23(3) of the Proposal).

Should the gain be entirely exempt from taxation?

Capital gains on shares are totally exempt in Austria, Belgium, Finland, Luxembourg, the Netherlands, Norway and Sweden. However, in some countries the consistency between taxation of gains and taxation of dividends makes it such that in most countries gains are subject to a 95% exemption which is intended to reflect non-deductibility of costs relating to an asset (the shares) that derives exempt income. This is the situation under the laws of Italy and Germany, which reflect the non-deductibility in a lump-sum taxation of the gain. In France, the amount of gains that is taxable is equal to 12% of the gross capital gain (it has been recently increased from 5% of the net capital gain to 10% of the net capital gain and finally 12% of the gross capital gain as from 1 January 2013). All these countries have applied the rule applying to dividends, which are also exempt with the exception of a limited percentage that is taxable to reflect non-deductibility of related expenses.

20. Paragraph 2.3.4.1 of the *Livre vert sur la coopération franco-allemande – Points de convergence sur la fiscalité des entreprises* (Feb. 2012).

21. Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB), COM(2011) 121/4, EU Law IBFD.

In Norway, the taxability of the capital gains was limited to 3% of the gain and equally applied to dividends. Recently, the taxation was abolished for capital gains and also for dividends paid to another group entity to secure elimination of double taxation within the same group.

The non-deductibility aspect has become a controversial issue in several countries under dividend taxation: firstly, it is unrelated to the ability to pay principle insofar as it is a non-rebuttable presumption, so that taxpayers are prevented from documenting a lower amount of expenses relating to the assets that generated the exempt income (i.e. the shares) and it discriminates non-resident corporate shareholders with no PE in the source state as they have no expenses in such state. Furthermore, it creates undesirable cascade effects when a corporate chain includes several companies and domestic law does not contemplate group consolidation (taking into account that some consolidation regimes – Italy is one example – do not permit consolidation of dividend income exclusively for reasons of revenue loss).²² These cascade effects occur when the gain is then distributed as a dividend and also subject to the limited taxation in those countries that also provide for a limited taxation of such income to reflect non-deductible expenses.

The same argument applies equally to capital gains. It is odd that this controversial provision finds its origin in the Parent-Subsidiary Directive, which permits²³ Member States to establish the amount of non-deductible costs relating to the dividends on a lump-sum basis equal to 5% of the dividend actually paid in. The issue becomes more interesting and perhaps doubtful when Member States increase the portion of gain to be subject to corporate tax. This is the case of France, which, as stated earlier, increased that portion from 5% to 10% and then to 12% of the gross capital gain. The higher the amount of taxable gain, the greater the departure from the purpose of the provision to reflect non-deductibility into partial taxation of the dividend. To the extent that the partial taxation of the gain reflects the legislature's intention to tax part of the gain rather than providing for non-deductible

22. The Italian consolidation regime was amended in 2007 (article 1(33)(s) of Law 244 of 2007) to eliminate the tax neutrality regime that was initially provided for dividend flows within the consolidation area.

23. EU Parent-Subsidiary Directive (recast) (2011): Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, EU Law IBFD, art. 4(3): "Each Member State shall retain the option of providing that any charges relating to the holding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5 % of the profits distributed by the subsidiary."

expenses, then partial taxation becomes compatible with EU law and the argument of a restriction on the non-resident shareholder who is unable to deduct expenses no longer becomes an issue.

This aspect raises the further point as to whether domestic legislation modelled on secondary EC law may fall under the jurisdiction of the ECJ taking into account that its case law so requires when Member States in shaping domestic law other than rules implementing secondary EU legislation openly and expressly take inspiration from EU provisions (see e.g. *Leur-Bloem* (Case C-28/95)).²⁴ Indeed, the provision of the Parent-Subsidiary Directive provides that, “Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5% of the profits distributed by the subsidiary.” The provision does not indicate if the election by the Member State includes the non-rebuttable presumption under which the corporate shareholder may not document the expenses to obtain a lower non-deductibility of the expenses. In its proposal for amendments to the Parent-Subsidiary Directive submitted in 2003,²⁵ the European Commission suggested reformulating article 4(2) to allow parent companies to prove the actual management costs incurred if lower than 5% in order to reduce the amount of non-deductible costs. However, such provision has not been included in the approved text of Directive 2003/123/EC of 22 December 2003 amending the Parent-Subsidiary Directive. It is interesting to note that such possibility has been included in the Commission’s CCCTB Proposal with respect to costs incurred in relation to income that is exempt under article 11.²⁶

24. NL: ECJ, 17 July 1997, Case C-28/95, *A. Leur-Bloem v. Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2*, ECR 1997 I-04161, ECJ Case Law IBFD, para. 27: “[T]he Court has repeatedly held that it has jurisdiction to give preliminary rulings on questions concerning Community provisions in situations where the facts of the cases being considered by the national courts were outside the scope of Community law but where those provisions had been rendered applicable either by domestic law or merely by virtue of terms in a contract (see, as regards the application of Community law by domestic law, *Dzodzi and Gmurzynska-Bscher*, cited above; Case 166/84 *Thomasdüniger* [1985] ECR 3001; Case C-384/89 *Tomatis and Fulchiron* [1991] ECR I-127 and, as regards the application of Community law by the effect of contractual provisions, Case C-88/91 *Federconsorzi* [1992] ECR I-4035 and Case C-73/89 *Fournier* [1992] ECR I-5621, all those cases being hereinafter referred to as ‘the Dzodzi line of cases’). In those cases, the provisions of domestic law and the relevant contractual terms, which incorporated Community provisions, clearly did not limit application of the latter.”

25. Proposal for a Council Directive amending Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, COM/2003/0462 final of 29 July 2003.

26. Art. 14(1) Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB): “The following expenses shall be treated as non-deductible: ... (g)

There are additional reasons to dislike the 5% mechanism for capital gains as it is more difficult to correlate the lump-sum expenses to the amount of extraordinary income such as a gain on shares. In addition, unlike dividends, the disposition of shares may trigger a loss and for this reason the loss should be deductible for at least 5%.

The 5% non-deductibility also creates distortions in some countries as items of expense incurred under the alienation are either added to the historical cost of acquisition or alternatively included in the current deductible expenditures.

Moreover, the 5% non-deductibility rule does not seem to be justified by the need to prevent an erosion of the tax base as the revenue deriving therefrom seems to be negligible. For example, in Italy, the tax revenue derived in 2010 from the taxation of 5% of capital gains subject to the participation exemption regime amounts to less than EUR 150 million.²⁷

For all these reasons, the exemption should be clear from conditions and provide a choice for the corporate shareholder to elect for the non-deductible expenses to be itemized rather than being determined on a lump-sum basis.

Taxation of gains realized by non-resident shareholders

In the Netherlands, the restriction has been lifted as a result of an infringement procedure initiated by the EU Commission so that taxation of gains realized by non-resident corporate shareholders is subject to tax solely if the purpose of the holding is to permit the avoidance of Dutch tax by a third party. Anti-abuse rules provide for taxation of the gain realized by a non-resident shareholder although the domestic participation exemption regime would apply to residents. This is so in Luxembourg, which provides that such gains on major shareholdings in a Luxembourg company are taxable if the shareholder had been a resident in Luxembourg for more than 15 years and moved residence outside Luxembourg in the 5 years preceding the date of the disposal. There may be doubts as to the compatibility of this provision with EU law provided that the taxpayer may not demonstrate that the change of residence was not made for the purpose of avoiding tax otherwise due on the disposal.

costs incurred by a company for the purpose of deriving income which is exempt pursuant to Article 11; such costs shall be fixed at a flat rate of 5% of that income unless the taxpayer is able to demonstrate that it has incurred a lower cost.”

27. EUR 144,366,000.

In Norway, non-residents having no permanent establishment (PE) in Norway are exempt from tax on capital gains realized on shares either in Norwegian or non-Norwegian resident companies.

1.3.3. Capital losses on shares – Tax deductibility and anti-abuse rules relating to dividend arbitrage schemes

1.3.3.1. Deductibility

Ring-fencing

In countries where capital gains are taxable to corporations, capital losses will be ring fenced, i.e., they will be deductible only from capital gains and not from ordinary income. They may be carried forward, either without limit (Australia, Canada)²⁸ or during a limited period (United States, 5 years). Sometimes, they may be carried back for a stated period (United States, Canada, 3 years).

1.3.3.2. Non-deductibility

In countries where capital gains on some categories of shares are exempt totally or partially, non-deductibility of capital losses will generally be the rule: the tax treatment of capital gains and capital losses is symmetrical.

Peculiarities must be noted in various tax systems.

In Austria, a difference exists between the treatment of capital gains and losses in the domestic field and in the international field. Capital gains on domestic shares being taxed at a 25% flat rate, losses on such shares must be prorated in the 7 years following their realization. The international participation exemption, applicable if the participation reaches 10%, extends to capital gains and excludes the deduction of capital losses. Deduction is allowed, however, for definite losses after they have been reduced by exempted profits of the previous 5 years: they are then prorated over 7 years. In addition, a corporation may opt during the year of purchase in respect of foreign participations for the tax regime of domestic capital gains and losses.

28. Sec. 111(1)(b) ITA.

In Belgium, capital losses on shares are disallowed even in the cases where capital gains would be taxable. However, losses will be deductible in the event of liquidation of the company in which the shares are held to the extent of its paid-up capital.

In the Netherlands, a capital loss on shares to which the participation exemption would apply is deductible in the case of liquidation of the subsidiary to the extent of the cost of the shares, which may be higher than the capital if the shares have been purchased. Logically, losses or write-downs on the realization of shares that do not qualify for the participation exemption are deductible in the Netherlands, leaving Belgium as the sole proponent of illogic.

France also applies a symmetrical regime: short-term and long-term (more than 2 years) capital losses are deductible except when realized on a “participation”, although the taxable percentage of gains on participations has been raised from 5%, which was similar to the taxable percentage of dividends, to 12% (of each gross capital gain). When long-term capital gains are taxable at the 19% rate (shares in listed real estate companies), capital losses may be carried forward during 10 years and be offset with long-term capital gains.

An asymmetrical regime will apply in Luxembourg: capital losses on transfer of shares are deductible even though the participation exemption would have applied to gains.

1.3.3.3. Anti-abuse rules

Wash sales

Sales engineered to realize a loss may be disregarded if they lack economic substance. In the United States, this will be the case if the taxpayer has an option to repurchase them during a 60-day period beginning 30 days before the sale.

Sales to related persons

Losses on sales to related persons are deferred until the stock is disposed of by the related person.

In Canada, when shares are acquired from a related party for an amount exceeding fair market value, they are deemed to have been acquired at their