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# Finance Ministry Targets Participation Exemption Regime

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# COUNTRY DIGEST

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## Finance Ministry Targets Participation Exemption Regime

Austria's Federal Ministry of Finance on March 11 presented a draft for the Tax Reform Act 2009 (Abgabenänderungsgesetz 2009), part of which would revise section 10 of the Austrian Corporate Income Tax Act (CITA), which governs the country's international participation regime.

Under the current participation exemption regime, dividends received by a company resident in Austria from a company also resident in Austria are always tax exempt, whereas dividends received from a company resident abroad are exempt only if a minimum holding requirement of at least 10 percent and a holding period of at least one year are met (the so-called international participation).

This regime, set out in section 10 of the Austrian CITA, incorporates article 4 of the EU parent-subsidiary directive into Austrian law, but also applies to dividends from third countries — for example, from a U.S. company (it is not limited to EU companies). Conversely, the treatment of capital gains is more beneficial for qualifying international participations, as capital gains from the alienation of a holding in a foreign company are in principle exempt from taxation, while they are taxable in a purely domestic setting.

There has been a debate for several years, however, about whether the differentiation between domestic and cross-border portfolio dividends is discriminatory and thus infringes on the fundamental freedoms set forth in the EC Treaty.

### Rulings on the Regime

This issue was first brought before the Austrian Tax Senate of Linz, which in its decision of January 13, 2005 (RV/0279-L/04), said that the regime constitutes a prohibited restriction of the free movement of capital and that taxpayers who do not fulfill the minimum holding requirement are nevertheless entitled to an analogous application of the exemption available to taxpayers receiving dividends from companies resident in Austria. The tax administration appealed the Tax Senate's decision before the Austrian Supreme Administrative Court (VwGH).

The VwGH on April 17, 2008, rendered its judgment in the case (2008/15/0064) without making a request for a preliminary ruling by the European Court of Justice. While the Supreme Administrative Court agreed with the Tax Senate's decision that the current regime infringes on article 56 of the EC Treaty and is superseded by EU law, it disagreed with the Tax Senate's holding that the exemption method should be applied analogously.

It argued that in light of the ECJ judgment in *FII Group* (C-446/04) (see *Doc 2006-24779* or *2006 WTD 239-10*), the violation of EU law can be remedied by granting an indirect foreign tax credit instead of an exemption, and that a tax credit would be more in line with the Austrian system and the legislature's intentions.

Based on that decision, the Ministry of Finance issued guidelines revising the existing regime. If a shareholding does not fulfill the criteria for exemption, a credit is granted for foreign corporate tax on all intercompany dividends from the EU member states and Norway; a credit for withholding taxes is granted only under double tax treaties.

To claim the indirect tax credit, the taxpayer must furnish detailed information to the tax authorities, including the name of the company distributing the dividends, the percentage of the shareholding, the corporate tax rate applicable to the distributing company, and the withholding tax levied (in the case of a treaty-reduced amount). Distributions from third-country companies may not benefit from this new interpretation.

### Referrals to the ECJ

The Supreme Administrative Court's decision, particularly because of its legislative effect, and the Finance Ministry's guidelines have been heavily criticized in legal writing. In two decisions issued on September 29, 2008, the Tax Senate decided to refer the original case, as well as a second case with similar facts, for a preliminary ruling by the ECJ.

The first case pending before the ECJ is *Haribo* (C-436/08), concerning whether the infringement of EU law may be resolved by applying the credit method (for cross-border portfolio dividends) as opposed to the generally applicable exemption method (for domestic dividends of any kind and cross-border nonportfolio dividends).

Another main issue is the burden of proof on the taxpayer, which is difficult to meet, particularly in the case of investment funds, because the data available to those investors such as annual reports of the fund generally lack the information required under the Finance Ministry's guidelines. The Tax Senate therefore inquires whether the tax administration should use the EU mutual assistance directive to gather the information instead of shifting the burden to the taxpayer.

The Tax Senate also has doubts about the impact of the free movement of capital on third-country portfolio dividends. (For the referral to the ECJ, see *Doc 2009-646* or *2009 WTD 8-22*.)

It will be interesting to see how the ECJ, after its judgment in *A* (C-101/05) (see *Doc 2007-27630* or *2007 WTD 244-11*), will continue to map the uncharted territory of how justifications in third-country situations deviate from intracommunity situations in terms of the increased justification leeway that member states have. Although the mutual assistance directive is not applicable to third countries, tax treaties may contain provisions on mutual assistance that might justify an analogous line of reasoning, as the ECJ has noted in scenarios in which the mutual assistance directive applies. It is therefore doubtful that the Finance Ministry's position that it is never necessary to grant at least a credit in third-country situations will withstand scrutiny.

The second case pending before the ECJ, *Österreichische Salinen* (C-437/08), is the continued proceeding following the VwGH's decision, which is now back at the level of the Tax Senate. In this case, the Tax Senate is mainly concerned about the practical impact of the credit method in lieu of the exemption method, especially regarding the amount of creditable tax and the question of a credit carryforward in loss situations; such a carryforward is generally not available under Austrian law, which may lead to discriminatory intertemporal double taxation. Also, the Tax Senate has asked whether the denial of a credit carryforward infringes on EU law when third-country portfolio dividends are at issue. (For the referral to the ECJ, see *Doc 2009-644* or *2009 WTD 8-21*.)

In light of these two referrals and without waiting for the ECJ's judgments, the Ministry of Finance on March 11 presented its draft tax reform. The draft will be presented to the Council of Ministers after it has undergone assessment by interested organizations, and it will then be submitted to the parliament and put to a vote before the summer break.

If the proposal is adopted, the main change to the current regime would be that the participation exemption would be extended to portfolio dividends (that is, dividends derived from shareholdings of less than 10 percent regardless of how long the shares are held) from EU companies, and also from companies in the European Economic Area if Austria and the EEA state have agreed on broad mutual assistance regarding the exchange of information and enforcement of tax claims. (Currently, only Norway has such an agreement with Austria.) For portfolio dividends from third countries, the treatment would remain unchanged; those countries are subject to corporate income tax at the 25 percent rate.

The draft leaves the current capital gains tax regime untouched, with support for that position in the explanatory notes. Accordingly, only qualified international participations (with minimum holdings of at least 10 percent, held for a year or more) may be disposed of tax free. Capital gains derived from the sale of any kind of shareholding in a domestic company or from the sale of a shareholding in a foreign company of less than 10 percent or that has been held for less than a year are subject to the 25 percent corporate income tax rate.

The draft introduces a new antiabuse rule in section 10, paragraph 5 of the CITA that would deny the tax exemption to otherwise qualifying portfolio dividends if the foreign distributing company is subject to low taxation. Such low taxation is assumed by fiction of law if:

- the distributing company is not effectively subject to a corporate income tax comparable to the Austrian corporate income tax;
- the foreign corporate income tax applicable is lower than 15 percent; or
- the distributing company has far-reaching tax exemptions (unless the exemptions are comparable to those provided for in section 10 of the CITA).

If criteria for the low taxation are met, foreign (portfolio) dividends would increase the domestic tax base. Any foreign corporate income tax paid may be credited toward the Austrian corporate income tax (section 10, paragraph 6, CITA).

The new antiabuse rule would be triggered regardless of whether the distributing company derives active or passive income. Accordingly, the rule is subject to fewer criteria and so is stricter than the current antiabuse rule in section 10, paragraph 4 of the CITA. This second proposed antiabuse rule would apply to shareholdings that fulfill the criteria of a qualified international participation (a minimum shareholding of at least 10 percent, held for a year or more) and would result in a switchover to the credit method, but only if the foreign company derives mainly passive income and is subject to low taxation.

The proposed legislation is very much in line with the expectations of most practitioners in light of the

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recent developments in case law. Because the exemption would be broadly extended to portfolio dividends, the change would remove many discriminatory aspects of the current regime that have been discussed in case law and legal writing; in that respect, it is also good that the new regime would apply to all open cases (section 26c, paragraph 18, CITA).

Nevertheless, the outcome of the two cases pending before the ECJ is awaited with interest, especially regarding third-country situations that are not covered by the March 11 draft of the Tax Reform Act 2009. ◆

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