EFB response
to consultation on taxation problems that arise when dividends are distributed acrossborders to portfolio and individual investors and possible solutions

The position of European Family Businesses on taxation of income from equity

Importance of taxation for family businesses

Fiscal issues related to family businesses are of key importance to both the family businesses and society at large. This is due to, firstly, the major importance of family businesses in terms of fostering and creating new jobs, giving rise to tax revenues, cherishing renewal and innovation, as well as contributing to sustainable development. Secondly, there are several tax issues that are characteristic of family businesses and particularly affect them.

For family businesses, taxation has three dimensions: business, current owners and future owners. Currently, in most European countries income from equity is subject to at least partial or even full double taxation: firstly, profit generated in the business is taxed at the applicable business tax rate. Secondly, the profit distributed by the business to its owners is taxed at owner level. Thirdly, when passed from one generation to another the business assets are often further taxed. In many cases this two-fold or even three-fold taxation causes the total tax burden of family businesses and their owners to be higher than the total tax burden of businesses held by other types of owners.

Focus on entrepreneurial initiative

Entrepreneurial initiative is vital for the development and prosperity of the economy both on the European and national level. The entrepreneurial initiative intrinsic in family businesses is typified by the long-term responsible ownership, sustainable growth and constant innovation. Therefore, it is important that the applicable tax system gives due consideration to the entrepreneurial risk related to a family business in comparison to other forms of investments, e.g. speculative financial investments.

The relevant measure to use in assessing whether a fiscal system creates disincentives or incentives for entrepreneurial risk is the Total Effective Tax Rate (TETR) on income from equity flowing to the owner through the business. Changes in the TETR alter the comparative attractiveness of investments into long term equity as compared to investments into other forms of capital such as deposits, bonds or property, which typically produce income that is subject to single taxation only. The TETR of investments in to equity can be influenced through changes to the tax burden on either the business level or the owner level or both.

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Single economic taxation on income from equity

European Family Businesses advocates a tax system that is based on single economic taxation on income from equity, i.e. single aggregate taxation of income at the hands of both the business and the owner. A tax system of this nature would establish tax neutrality in several important aspects (see below).

Furthermore, European Family Businesses believes that any tax system should be such that it does not dampen the capability of businesses to play their role as engines of the economy. A tax system that incentivises family businesses to retain and reinvest earnings would enable members states to maximise their tax revenues on a sustainable long-term basis (see EU Commission Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity, 15 February 2008).

Tax neutrality between equity and debt

Income from equity should not be subject to more severe taxation than income from other types of capital, e.g. bonds, deposits or property. The comparison between the tax implications of debt and equity should be made based on TETR on the income.

In the current economic downturn, the importance of a strong balance sheet with a solid amount of equity is emphasized. One important factor contributing to the retention of earnings is taxation (see EU Commission Study on Effects of Tax Systems on the Retention of Earnings and the Increase of Own Equity, 15 February 2008).

According to a report by the High Level Group chaired by Wim Kok (Facing the Challenge: The Lisbon Strategy for Growth and Employment, November 2004), company financing in Europe is currently too lending based and not enough equity based. "This makes it especially hard for start-ups and SMEs to attract sufficient financing, as they cannot meet the demands for guarantees by traditional financial institutions", the report says.

However, in most European countries, in terms of taxation, equity in the form of paid-in capital and retained earnings is treated unfavourably in comparison to debt: businesses receiving their assets in form of debt are allowed to deduct the interest payments in its taxation. On the other hand, dividends paid on equity are not deductible for the payer. From the perspective of the owner, dividend income is mostly only partly exempted from tax, therefore, giving rise to partial double taxation.

Private investment is a key issue for promoting strong, sustainable and equitable growth of business. If the Commission wishes to promote a long-term sustainable and responsible investment environment, measures need to be taken to ensure that businesses are not so reliant on debt. This would encourage the flow of private and household savings to businesses and thus contribute to economic growth in Europe.

Tax neutrality between dividends and capital gains

Dividends and capital gains should be subject to equal taxation. This form of neutrality removes the incentive of the disposal of one's share in a business instead of holding it and deriving profits from it on a long-term basis. Neutrality promotes continuity and sustainable development of the business and its interest groups, such as owners and their families, employees, suppliers, and the fiscal unity.

Taxes on transfers of family business are taxes on enterprises

In addition to corporate income tax paid by the company and dividend tax paid by the owner in possibly two member states, this double or triple taxation could be topped by another level of taxation in connection with the transfer of a family business to the next generation. More often than not assets have to be extracted from the business in order for the gift recipient or heir to be able to pay the taxes due. Such funds are often provided by the business in the form of dividend, where they weaken the ability of the business to grow and invest and trigger dividend tax, possibly both in the source state and the residence state. For further information on the problems caused by the combination of dividend tax and inheritance or gift tax for family businesses, please see the contribution of EFB from 22 September 2010 to the EU Commission Consultation on possible approaches to tackling cross-border inheritance tax obstacles within the EU.

EUROPEAN FAMILY BUSINESSES

Tax neutrality between different kinds of owners

As a combination of the above-mentioned points, European Family Businesses desires a tax system that treats the owners of family businesses equally in comparison to other kinds of owners. The comparison should be made on a three-dimensional basis (business   current owner   future owner) and not separately at business or owner level as often is the case. Of all types of companies only businesses held by households face recurring taxes on the basis of their assets, while companies held by owners of a more perpetual nature (e.g. foundations, institutional investors, co-operatives, states or municipalities), face no such taxation. This provides non-family businesses with an unfair competitive advantage in their ability to accumulate capital.

Finally, be it equity or debt, business assets or speculative investment assets, or the aim of long-term holding or short-term disposal of assets, the tax system should be neutral towards them all. It should create a level playing field for all forms of savings and all types of owners.

Cross-border dividend tax obstacles for individual investors within the EU

Impact of dividend tax on family businesses in a cross-border context

European Family Businesses considers that attention should be paid to cross-border dividend tax obstacles and they should be effectively tackled. It is obvious that international double taxation is an obstacle to cross-border activity and investment within the European Union.

As mentioned above, dividend tax poses several challenges to family businesses at a national level. The reason why cross-border withholding tax problems faced by portfolio and individual investors in the EU affect especially family businesses rather than other businesses is the question of type of ownership: the owners of family businesses are individuals. Subsequently, when double or even more-fold taxation occurs in cross-border dividend distribution situations, the negative implications of taxes on family businesses may grow substantially larger than in a purely national context. It would limit the will and possibilities of the businesses and their owners to move and operate cross-border within the Internal Market.

With regard to cross-border dividend taxation of individual investors, family business owners are often in a more problematic situation than portfolio investors investing in other assets than their own family business. This is due to the long-term nature of the ownership of the family business owners. In case of double taxation on cross-border dividends, portfolio investors have the possibility of converting their dividend income into capital gains by selecting investment instruments such as investment funds (Collective Investment Vehicles) that do not distribute dividends but where the investor can realise his/her share of the accumulated profit by disposing of his/her share in the CIV. Although the CIV might face double taxation as a portfolio investor as well, the family business owner in practise almost never has such possibility of converting his/her dividend income into capital gains.

Impact of dividend tax on the neutrality between equity and debt in a cross-border context

Cross-border interest payments seldom lead to double juridical taxation between EU member states, because several member states abstain from taxing outbound interest payments either based on their national legislation or the double tax conventions entered by them. However, the member states hardly ever give up their right of levying withholding tax on outbound portfolio dividends. Therefore, in addition to the lack of neutrality between equity and debt mentioned above, cross-border context gives it a further edge.

The position of European Family Businesses on the economic double or multiple taxation of cross-border dividends paid to individual investors

European Family Businesses believes that the ultimate aim should be tax neutrality between income from equity and income from debt. The optimal way to reach this goal would be the removal of both the juridical and the economic double taxation of income from equity.

Juridical double taxation refers to the taxation of the same dividend income in, firstly, the source state where the distributing company resides and, secondly, in the residence state of the owner i.e. the recipient of the dividend. Economic double taxation of equity   the relief from which to the extent of ensuring neutrality between different kinds of investments and owners is one of the major goals of European Family Businesses refers to the taxation of the profit, firstly, at the business level and, secondly, at the hand of the owner. National tax systems often provide a method for the partial relief of economic double taxation of dividend. The relief may take place either at the business level or the owner level.

However, as mentioned also in the Consultation Document of the Commission, member states are not per se required to relieve economic double taxation and such relief is generally not addressed in double tax conventions. Therefore, the introduction of a cross-border element may exacerbate the problem of economic double taxation possibly present already in a purely national context. Please find below an example of such a situation.

> The business resides in member state A, which applies the partial exemption of dividend income from tax as a method of relief from economic double taxation of dividends. The owner of the business resides in member state B, which in turn relieves economic double taxation by granting a specific deduction from taxable profits at the level of the business.
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> The state of residence of the business, member state A, levies corporate income tax on the profit of the business but relieves the dividend from withholding tax. However, member state B as the state of residence of the owner levies a full dividend tax on the dividend. This is due to that the method of relief from economic double taxation member state B applies concerns the business level, not the owner level. Therefore, although no juridical double taxation of dividend exists between the two member states and although both member state A and member state B have a method of relief from economic double taxation of dividends in place, the dividend distributed cross-border is subject to full taxation at both business level and owner level without a possibility of tax credit.

Possible solutions to the problems faced by portfolio and individual investors

Based on what has been mentioned above, from the viewpoint of European Family Businesses, the optimal solution for ensuring the equal taxation of income from equity and income from debt as well as income from other types of investments in a cross-border context would be Option 6. I.e. no withholding tax in the state of source and no taxation of foreign source dividends in the State of residence. In such a situation, the income from equity would be subject to single economic taxation at the level of the business but not further at the owner level equally to e.g. income from deposits or property.

However, due to the several notable disadvantages related to Option 6 and mentioned in the Consultation Document, such as loss of tax revenue for both source and residence member states as well as the possibility of zero-taxation, European Family Businesses finds the other options mentioned by the Commission more realistic to reach in the close future.

Options 1 to 4 are methods of relieving juridical double taxation. They are in such to a large extent feasible, but, as mentioned also by the Commission, do not completely solve the issue of economic double taxation of dividends in cross-border situations. Therefore, European Family Businesses does not regard them as comprehensive enough solutions to fully tackle dividend double taxation problems faced by individual investors in the EU.

However, European Family Business considers Option 1 to be a feasible alternative that could be taken to improve the neutrality between income from equity and income from debt. It could be the first step towards a level playing field for all forms of savings and all types of owners.

As a further step, European Family Businesses considers Option 5 to be worth examining as an alternative that remedies both the juridical and the economic double taxation of dividend. Option 5 and does not give rise to such loss of tax revenues of the member states as Option 6 does.

In practise, Option 5 is based on the solution of relieving both juridical and economic double taxation by the common measures of the two member states concerned. Firstly, the Option would remedy juridical double taxation in the following way:

1. The source state would limit its withholding tax on dividends. If and how much the source state limits its withholding tax would depend on negotiations between the source state and the residence state on how to distribute tax revenue.
2. The residence state, on the other hand, would provide full credit for the withholding tax levied by the source state. Subsequently, the dividend income would be taxed only once at the level of the owner, i.e. there would be no juridical double taxation.

Secondly, Option 5 would remedy economic double taxation as follows:

1. The residence state would provide limited underlying tax credit that is based on the calculated corporate income tax burden of the business in the source state. The credit would be limited to a certain percentage of the corporate income tax burden of the business and would be dependent on negotiations between the member states.
2. Subsequently, the economic double taxation of the dividend at, firstly, the business level and, secondly, the owner level would be partly relieved.

In effect, the two member states would reciprocally form a system of a (partially) single economic taxation of income from equity that is normally available only in a purely national context. This would be achieved by the two member states agreeing on how large a share of the double taxation relief is provided by the source state and how large share by the residence state. The crucial factor of distributing the cost of the system between the member states would be to which extent would the source state be ready to limit its withholding tax. The larger the limitation applied by the source state would be, the more would the residence state be able to levy tax on the dividend as the amount of source state tax it would need to credit would decrease.

An example to illustrate the operation of the system:

1. Normal credit method

The business resides in member state A, which imposes a tax of 25 % on the corporate profit of the business amounting to 100. On the dividend of 75 distributed by the business, member state A would levy a withholding tax of 15 %. Hence, the TETR of the dividend would be 36,25 % and would give rise to a tax revenue of 36,25 to member state A.

Member state B is the residence state of the owner of the business. It applies a corporate tax of 20 % on business profits. On dividends, it applies a capital income tax rate of 20 %, resulting in a TETR of 36 % in a national context.

When the normal credit method is in use, member state B would levy a tax of 20 % on the dividend received by the owner from member state A and would grant a credit for the withholding tax levied by member state A. The amount of tax revenue of member state B would be 3,75.

In total, taking both member states into account, this would result in a TETR of 40 % on the profit generated by the business, which is over 11 % higher than the TETR would be in a purely national context in member state B. Hence, economic double taxation arises.

2. Underlying credit method (Option 5)

Having agreed on the underlying credit method, member state A would have agreed to decrease its dividend withholding tax rate from 15 to 10 percent. Member state A would levy a tax of 25 on the corporate profit and a withholding tax of 7,5 on the amount of dividend distributed. The tax revenue of member state A would be 32,5.

Member state B would levy a tax of 20 % on the dividend received by the owner from member state A and would grant a credit for the withholding tax (10 %) levied by member state A. In addition, member state B would grant a credit of 4 which represents 1/6 or 16,7 % of the corporate income tax levied by member state A. Therefore, on the gross dividend of 75 distributed by the business, member state B would levy a tax of 20 % i.e. 15, but it would grant a credit for the withholding tax of 7,5 levied by member state A and an underlying tax credit of 4. The amount of dividend tax payable by the owner and the tax revenue of member state B would be 3,5.

In total, taking both member states into account, this would result in a TETR of 36 % on the profit generated by the business, which is the same than TETR would be in a purely national context in member state B. Hence, no economic double taxation arises. The cost of the underlying tax credit method for the member states would be 4, whereof member state A would carry 3,75 and member state B 0,25. Sharing tax revenue between the member states would be based on their mutual agreement.

In European Family Businesses's view, the major benefit of Option 5 described above would be the elimination of both juridical and economic double taxation of business profits, which would improve neutrality between equity and debt as well as income from equity and income from other forms of investments. As described above, this would allow for a flow of capital into businesses instead of passive investments, which would encourage employment, investment and growth. This would strengthen the tax revenue base of the member states and, thus, remedy the partial loss of tax revenue related to the introduction of the system. Therefore, European Family Businesses regards Option 5 as the most suitable of the alternatives mentioned by the Commission for, simultaneously, effectively remedying the juridical and economic double taxation of individual investors' dividends, as well as promoting economic growth in the EU.

Brussels on 19 April 2011

European Family Businesses is a federation of 11 national family businesses associations. Our aim is to make political decision makers aware of the contribution of family businesses to society at large and to promote policies that are conductive to long term entrepreneurship. Our members represent turnover in excess of one trillion Euro, 9% of European GDP.