INFORMATION SHEET NO.37

The Parent Subsidiary Directive

September 2003

Introduction

The Parent / Subsidiary Directive (EU Directive 50/435/EEC dated 23 July 1990) deals with the tax regime applicable to parent and subsidiary companies of the Member States and eliminates any double taxation of dividends paid by a subsidiary in one Member State to a parent company in another Member State.

A Parent / Subsidiary relationship is established where a parent holds 25% or more of the capital of the subsidiary company in question. The Member States may require that the parent company maintain the minimum holding for an uninterrupted period of at least one or two years, an option utilized by a number of Member States.

The net result of the provisions of this Directive is that the Member State of the subsidiary must exempt the dividend paid from withholding tax and the Member State of the parent company must either exempt the incoming dividend (exemption method applied e.g. by Germany, Austria, Sweden, Luxembourg and the Netherlands) or tax it but grant a credit for the underlying corporation tax paid by the subsidiary in its Member State (credit method applied by e.g. the United Kingdom, Ireland and Spain). Moreover the Member State of the parent company may treat expenses relating to the holding such as loan interest and losses resulting from the distribution of profits as non deductible in the hands of the parent company. Where however management costs are determined at a flat rate, only a maximum of 5% of the distributed profits can be treated as non deductible.

Implementation into Cyprus Law

The Special Contribution for the Defence Tax Law implements the Parent / Subsidiary Directive into the Cyprus legislation. The Special Contribution for the Defence Tax Law goes further than required by the Directive and is in this respect more generous in its terms. In accordance with the provisions of this Law, dividends received by a Cyprus resident are taxed at the rate of fifteen per cent (15%), except the following:

- Dividends paid from one Cyprus resident company to another.
- Dividends received from an overseas company by a resident company of Cyprus or a company which is not a resident of Cyprus but has a permanent establishment in Cyprus, holding directly at least one per cent (1%) of the share capital of the overseas company. This exemption does not apply if a) more than fifty per cent (50%) of the paying company's activities result directly or indirectly in investment income **and** b) the foreign tax burden on the income of the company paying the dividends is substantially lower than the Cypriot tax burden.

The conjunction "and" implies that both criteria have to be met in conjunction with the 1% holding (which is a constant) for the exemption to not apply.

For outgoing dividends, there is no withholding tax in Cyprus, whether or not the jurisdiction of destination is within the EU.

Anti Avoidance Provisions

Although the Directive does not contain any anti abuse provisions itself, it makes clear from the outset in Article 1 that it does not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. A number of EU countries have imposed such anti abuse legislation in their interpretation of the Parent / Subsidiary Directive. The low tax jurisdiction provision utilized by Cyprus above, is one example of such an anti avoidance provision. The three most common anti avoidance provisions introduced by the Member States for this purpose are:

- An obligation on the parent company to certify that it is not directly or indirectly controlled by persons resident outside the EU. Spain, France, Germany, Austria and Italy have all enacted this anti abuse provision in their domestic laws. An important proviso is that this provision is normally overridden if the non-EU control can be justified on commercial grounds. Non-EU controllers of an EU parent company with a group of subsidiaries in more than one Member State may validly claim the benefits of the Directive on commercial grounds.
- An obligation on the parent company to certify that it is the beneficial owner of the dividend income. (Beneficial ownership of dividend income is a pre-requisite for benefit under the dividend articles of most of Cyprus' double tax treaties. It is also a requirement of benefit under the Directive under the anti-avoidance
- laws of most Member States). Cyprus' domestic system of credit relief for foreign corporation taxes underlying foreign income dividend flows means that the CHC will pay little or no Cyprus corporation tax on its income from foreign dividends whether or not it beneficially owns the income.
- An obligation on the parent company to certify that it holds at least 25% of the voting capital of the subsidiary and has done so for a minimum uninterrupted period of one to two years. As with the other options, this option has not been uniformly adopted by all the Member States: whilst the United Kingdom has no minimum qualification holding period, Denmark, France, Italy, Luxembourg and Spain require a two year ownership period and Germany and the Netherlands require only a one year ownership period. The divergent applications in different Member States has meant that it is considerably harder to meet the "participation exemption criterion" in certain jurisdictions rather than in others. In Denmark for example, the 25% threshold is more difficult to meet than the Spanish threshold of 5%. There are subtler nuances in the legislation however, which must also be considered - Denmark for example, excludes from the participation exemption rules, any income and capital gains derived from "financial" companies (defined as an entity of which more than 33% of its income is passive). Spain excludes all "passive income". Denmark may therefore be preferred in this respect.

It should be noted that the European Court of Justice (ECJ) has clarified that Member States are not entitled to require that the minimum holding period be completed at the time when profits that are subjected to the tax advantage afforded by the Directive are distributed. This period can therefore be completed after the distribution.

The ECJ did note however that the Member States may require the payer to withhold tax provisionally or lodge a security equal to the tax until the parent company proves that the minimum holding period has been met.

Parent / Subsidiary Directive or Double Tax Treaty

Where a company is resident in the EU and has the choice of invoking the Parent / Subsidiary Directive or a Double Tax Treaty concluded by the Member State of the parent and the Member State of the subsidiary, it is advisable that it invoke the Directive in preference to a Double Tax Treaty because the Directive eliminates withholding taxes on inter corporate profit distributions within the EU altogether whereas a Double Tax Treaty normally only reduces the applicable rate of withholding tax.

However, if a country enters into a Double Tax Treaty and then subsequently into a multilateral treaty which has supremacy over the Double Tax Treaty such as the Parent / Subsidiary Directive then the provisions of the Double Tax Treaty may still be relevant if the Directive's provisions are not fulfilled, i.e. if the holding does not exceed 25% or if any anti abuse provisions noted above disable access to the Directive.

Proposal to broaden the reach of the EC Parent / Subsidiary Directive

On 29 July 2003 the EU Commission filed a proposal for amending the EC Parent / Subsidiary Directive, broadening its reach. The proposal includes the following:

a) explicitly extending the shelter of the Directive to permanent establishments;

b) lowing the minimum participation requirement from 25% to 10%;

c) preventing the double taxation on dividends received from hybrid entities by preventing the parent company jurisdiction from taxing the profits of the hybrid entity twice;

d) requesting those parent company jurisdictions which opt for relief from double taxation through indirect tax credits to extend those credits to lower tier qualifying subsidiaries;

e) requesting those parent company jurisdictions which opt for relief from double taxation through an exemption of 95% of the income received to grant a higher exemption if the taxpayer can prove that its tax deductible management costs regarding the participation constituted less than 5% of the profit distributions received;

f) expanding the list of qualifying entities under the annex to the Directive.

Amendment to the Directive is partly prompted by the fact that at present it applies only to operations between companies liable to corporation tax which do not enjoy the right to opt to be so liable and which take one of the legal forms set out in the Annex to the Directive. As a result, certain dividend distributions are not covered by the Directive even where the entities concerned are fully liable to corporation tax and pay or receive dividends.

If adopted, Member States must have implemented the proposed changes to the Directive by 31 December 2004.

NOTES:

The above is intended to provide a brief guide only. It is essential that appropriate professional advice is obtained. Totalserve Management Ltd will be glad to assist you in this respect. Please do not hesitate to contact us.