# The switch-over clause

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# The switch-over clause according to the Commission

- **CCTB Proposal, Recital § 16**

- « As far as specific anti-tax avoidance measures are concerned, it is often necessary to ascertain the level of taxation on the other side of the border, in order to determine whether the taxpayer is liable to pay tax on foreign generated income. This would create a **level-playing field** regarding the level of tax and competition within the internal market and also protect the market from **base erosion vis-à-vis third countries**. In this context, it is necessary to provide for a switch-over clause targeting some types of income earned in a third country, such as profit distributions and proceeds from the disposal of shares, in order to ensure that income be taxable in the Union if it has been taxed below a certain level in a third country"

# Two steps

- **Art. 53 CCTB**
- 1. By way of derogation from points (c) and (d) of Article 8, a taxpayer shall not be exempt from tax on foreign income that the taxpayer received as a profit distribution from an entity in a third country or as proceeds from the disposal of shares held in an entity in a third country where that entity in its country of tax residence is subject to a statutory corporate tax rate lower than half of the statutory tax rate that the taxpayer would have been subject to, in connection with such foreign income, in the Member State of its residence for tax purposes.
- The first subparagraph shall not apply where a convention for the avoidance of double taxation (…) does not allow switching over from a tax exemption to taxing the designated categories of foreign income.
- 2. Where paragraph 1 applies, the taxpayer shall be subject to tax on the foreign income with a deduction of the tax paid in the third country from its tax liability in the Member State where it is resident for tax purposes. The deduction shall not exceed the amount of tax, as computed before the deduction, which is attributable to the income that may be taxed.
- 3. Member States shall exclude losses from the scope of this Article in the event of a disposal of shares in an entity that has its residence for tax purposes in a third country.
- **Art. 72 CCCTB** : reference to statutory rate of taxpayer replaced by average statutory corporate tax rate applicable amongst all Member States instead

# I- A THEORETICAL APPROACH OF THE SWITCH-OVER CLAUSE

# Comparative approach of switch-over clauses

| | CCTB 2016 (art. 53) | ATAD draft (art. 6) | CCCTB 2011 (art. 73) |
|---|---|---|---|
| **Type of income** | Profit distributions<br>Capital gains<br>**... *** | Profit distributions<br>Capital gains<br>**Income from a PE** | Profit distributions<br>Capital gains<br>Income from a PE |
| **Low-tax entity** | **Statutory** CIT rate in third State < **50**% Statutory CIT rate in residence State<br><br>[CCCTB step : EU average] | Statutory CIT rate in third State < 40% Statutory CIT rate in residence State | 1) Statutory CIT rate in third State < 40% average CIT rate in EU<br>or 2) Special derogatory regime in third State |
| **Switch-over clause not applicable** | **DTC exception**<br>Losses | No DTC exception<br>Losses | No DTC exception |
| | | | |
| | * Bug in Art. 54? | | |

# A new philosophy?

- **The switch-over clause does not apply to PE income any longer**
  - PE income in a low-tax country is covered by CFC rules (art. 59/60)
  - This is one of the reasons why the switch-over clause was removed from ATAD
  - So the switch-over clause cannot be interpreted as an exception to the principle of territoriality (in a strict sense) anymore
- **The switch-over clause applies to profit distributions**
  - Case 1 : in case the distributing company is a CFC under art. 60
    - Art. 60.4 provides that distribution of CFC income cannot be taxed again ➔ art. 60. 4 (*lex specialis*) seems to prevail over Art. 53 ➔ switch-over clause useless
  - Case 2 : in case the distributing company is not a CFC under art. 60 (for instance because it is not controlled by the beneficiary of the dividend)
    - switch-over clause philosophy : taxation of underlying profits of the distributing company at the time of distribution ; complementary approach to CFC rules which operate immediately

# A new philosophy?

- **The switch-over clause applies to capital gains on shares**
  - Philosophy :
    - higher value of shares is attributable to undistributed profits of the company ➔ capital gain economically equivalent to a profit distribution *[to be discussed...]*
    - Complementary to CFC rules since the switch-over clause also encompasses capital gains on shares of a CFC

# Theoretical flaws of the switch-over clause?

- **Distortion between Member States depending on their statutory rate**
  - Compatible with Recital § 16 on level-playing field?
  - Strange results in the case of a joint venture with partners taxed at different rates

- **No safe harbour clause allowing taxpayer to prove absence of base erosion scheme**
  - Philosophical flaw?
    - Compatible with Recital § 16 on base erosion?
    - More fundamentally, if economic activity is performed in the third State, BEPS philosophy implies to tax where value is created ➔ no taxation in the shareholder State
  - Technical flaw?
    - Principle of proportionality of EU law
    - Constitutional constraints (French case law on CFC rules could be adapted to switch-over clause)

# II- A TECHNICAL APPROACH OF THE SWITCH-OVER CLAUSE

# Income concerned

- The taxpayer shall not be exempt from tax **“on foreign income (…)** received **as a profit distribution** from an entity in a third country”
  - Note that the text does not say “shall not be exempt from tax on profit distributions…”.
  - It applies to “foreign income” received “as” a profit distribution
  - Seems to imply that if the profit distribution includes “non-foreign” income, part of the distribution is not subject to the switch-over clause (ex. : case of a company in a low-tax third country with a PE in the country of residence of the beneficiary)
  - What if the “foreign income” has its source in another third country which is not a low-tax country?
  - Should we always look at the connection between the amount distributed and the location of the underlying income?
  - If so, how to apply this in case of a capital gain? Should one check that all or part of the capital gain corresponds to an underlying “foreign” income?
  - Strict or broad concept of profit distribution ?

# Subject to tax condition

› … where that entity in its country of tax residence is **"subject to** a statutory corporate tax rate"…

- "Subject to"" not equivalent to "liable to"? Seems to refer to effective tax burden, but that is contradictory to the reference made to the statutory CIT rate (which may not be applied in practice)
- Comp. ATAD draft, Recital 8 : "Considering that the switch-over clause does not require control over the low-taxed entity and therefore access to statutory accounts of the entity may be unavailable, the computation of the effective tax rate can be a very complicated exercise. Member States should therefore use the statutory tax rate when applying the switch-over clause".
  - But note that the switch-over clause in ATAD was not worded identically : "where the entity (…) is subject (…) to a tax on profits at a statutory corporate tax rate lower than 40 percent of the statutory tax rate that would have been charged under the applicable corporate tax system in the Member State of the taxpayer".

# Subject to tax condition

- Foreign statutory rate compared to the half of the statutory rate “that the taxpayer would have been subject to, in connection with such foreign income”
  - “In connection with” = “assuming that the underlying income of the distributing company would have been directly attributed to the beneficiary of the dividend”?
  - Practical question : what if the foreign entity is a holding company receiving tax exempt dividends? Is the statutory rate deemed to be equal to zero (which would be consistent with the BEPS inspiration of the text) or should it make a difference that both States have different nominal CIT rates?

# Tax credit

- **“**The taxpayer shall be subject to tax on the foreign income **with a deduction of the tax paid in the third country”**
  - Which tax exactly should be credited? Direct or indirect tax credit? Both?
    - Direct tax credit : does not seem to be the intention of the authors of CCTB Proposal
    - Indirect tax credit : more in line with the intention to tax underlying foreign income.
  - Specific issues concerning capital gains
    - Direct tax credit ? In many cases, no tax will be levied in the third country upon the capital gain
    - Indirect tax credit : practically difficult to apply an indirect tax credit on capitalized profits (which ones, by the way? Passed profits? Future profits?) on the base of the assumption that capital gain = capitalized profits...
  - How does the deduction take place if the beneficiary is in a loss-making situation?

# Exclusions

- **Double tax treaties not allowing switch-over**
  - Some treaties allow switch-over
  - Most treaties seem not to allow switch-over ➔ does the exception ruin the principle?

# Exclusions

- **Losses in the event of a disposal of shares**
  - "Member States shall exclude losses from the scope of this Article" : i.e. no exception to Art. 8, c)
    - 8, c) : proceeds from the disposal of shares shall not be included in the tax base ; proceeds may mean capital losses ➔ No deduction of losses
  - Non-deductibility of capital losses creates asymmetry between treatment of capital gains and capital losses ; consistent with primary EU law?
    - Compare Corp. A (parent) selling Corp. B (domestic sub) and Corp. C (third country sub)
    - If Corp. A makes a capital loss on Corp. B, it is generally not deductible ; so no difference with treatment of capital loss on shares of Corp. C by virtue of switch-over clause
    - ... But if Corp. A makes a capital gain on Corp. B, it is tax exempt ; while the same capital gain on Corp. C would be taxed by virtue of switch-over clause
    - ➔ clear disincentive to invest in Corp. C

***THANK YOU FOR YOUR ATTENTION***