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INSIGHTS

OUTBOUND ACQUISITIONS: EUROPEAN HOLDING COMPANY STRUCTURES

Insights Special Editon

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EDITORS' NOTE

This special edition of *Insights* addresses the use of holding companies in Europe. The emphasis is on the tax benefits that may be obtained outside the U.S. for revenue generated by a holding company in a way that does not run afoul of the anti-deferral rules of U.S. tax law.

For many years, it was sufficient for tax advisers to understand the scope of benefits that were available to holding companies in a particular country and the steps that were required to achieve the desired goals. Often, the benefits reflected favorable rulings, special tax regimes, and lack of congruence in the way entities or transactions were viewed under the tax laws of two or more countries. All planning contained a residual element, *viz*., the use of structures that allowed foreign profits to be permanently invested outside the U.S. for financial accounting purposes and that did not result in the loss of deferral for U.S. income tax purposes.

The landscape has changed over the past 18 months: tax benefits derived from these arrangements have been vilified in the media, in parliamentary hearings, by the G-20 countries, and by the O.E.C.D., through its B.E.P.S. project. Countries around the world are changing their laws in a frenzy to eliminate tax planning that was universally deemed to be acceptable in past years. As a result, the use of holding companies as a tool for global planning now requires both a knowledge of local tax laws and a sensitivity to the use of planning tools that are not viewed as abusive under current standards.

This edition of *Insights* examines the benefits that are obtainable in 15 European jurisdictions. It also addresses the new reality that results from the B.E.P.S. project of the O.E.C.D. and several initiatives of the European Commission that are intended to eliminate cross-border tax planning arrangements. The authors are leading tax lawyers in their respective countries and recognized experts on B.E.P.S. and the European Commission initiatives.

We hope you enjoy this issue.

– The Editors

This edition of *Insights* is based on material written by the same authors and published in different format as "Chapter 274" of the *Corporate Tax Practice Series: Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Reorganizations & Restructurings 2015,* edited by Louis S. Freeman, available at 1-800-260-4754; www.pli.edu.

INTRODUCTION

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IN GENERAL

When a U.S. company acquires foreign targets, the use of a holding company structure abroad may provide certain global tax benefits. The emphasis is on "global" because standard U.S. benefits such as deferral of income while funds remain offshore may not be available without further planning once a holding company derives dividends and capital gains.

If we assume the income of each foreign target consists of manufacturing and sales activities that take place in a single foreign country, no U.S. tax will be imposed until the profits of the target are distributed in the form of a dividend or the shares of the target are sold. This is known as "deferral" of tax. Once dividends are distributed, U.S. tax may be due whether the profits are distributed directly to the U.S. parent company or to a holding company located in another foreign jurisdiction. Without advance planning to take advantage of the entity characterization rules known as "check-the-box," the dividends paid by the manufacturing company will be taxable in the U.S. whether paid directly to the parent or paid to a holding company located in a third country.[1] In the latter case, and assuming the holding company is a controlled foreign corporation ("C.F.C.") for U.S. income tax purposes, the dividend income in the hands of the holding company will be viewed to be an item of Foreign Personal Holding Company Income, which generally will be taxed to the U.S. parent company or any other person that is treated as a "U.S. Shareholder" under Subpart F of the Internal Revenue Code.[2]

BENEFITS OF HOLDING COMPANIES

Nonetheless, the use of a holding company can provide valuable tax-saving opportunities when profits of the target company are distributed. Historically, the use of

The authors acknowledge Jennifer Lapper, the Events and Marketing Director of Ruchelman P.L.L.C., and Francesca York, a Paralegal at Ruchelman P.L.L.C., for converting 17 separate submissions prepared by persons having a multitude of birth languages into a cohesive and accurate monograph.

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1 Section 301.7701-3(a) of the Income Tax Regulations. If an election is made for a wholly-owned subsidiary, the subsidiary is viewed to be a branch of its parent corporation. Intra-company distributions of cash are not characterized as Foreign Personal Holding Company Income, discussed later in the text.

2 There are exceptions to the general characterization of a dividend as an item of Foreign Personal Holding Company Income that might apply. One relates to dividends received from a related person which (i) is a corporation created or organized under the laws of the same foreign country as the recipient C.F.C. and (ii) has a substantial part of its assets used in its trade or business located in that foreign country. See Code §954(c)(3)(A)(i). For a temporary period of time, a look-through rule is provided in Code §954(c)(6), under which dividends received by a C.F.C. from a related C.F.C. are treated as active income rather than Foreign Personal Holding Company Income to the extent that the earnings of the entity making the payment are attributable to active income. This provision is regularly adopted for two-year periods, after which it must be re-enacted. The latest version was terminated at the conclusion of 2014.

a holding company could reduce foreign withholding taxes claimed as foreign tax credits by the U.S. parent. This could be achieved through an income tax treaty, or in the case of operations in the E.U., through the Parent-Subsidiary Directive. This can result in substantial savings if the operating and tax costs of maintaining the holding company are significantly less than the withholding taxes being saved. However, as will be described below, the E.U. has taken steps to modify the Parent-Subsidiary Directive so that it does not apply when the parent is in turn owned by a company based outside the E.U. and the structure is viewed to be abusive.

"The use of a holding company can provide valuable tax-saving opportunities when profits of the target company are distributed."

Although the foreign tax credit is often described as a "dollar-for-dollar reduction of U.S. tax" when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality is quite different. Only taxes that are imposed on items of "foreign-source taxable income" may be claimed as a credit.[3] This rule, known as "the foreign tax credit limitation," is intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S. taxable income.

The U.S., as with most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income. It also prevents so-called "cross crediting" under which high taxes on operating income may be used to offset U.S. tax on lightly-taxed investment income. For many years, the limitation was applied separately with regard to eight different categories of "baskets of income" designed to prevent the absorption of excess foreign tax credits by low-tax, foreign-source income. In substance, this eviscerated the benefit of the foreign tax credit when looked at on an overall basis. The problem has eased now because the number of foreign tax credit baskets has been reduced from eight to two: passive and general.

On the other hand, the Administration's tax proposals would impair the ability of U.S.-based multinational groups to choose whether to receive dividends from highly-taxed or lightly-taxed foreign corporations by putting all earnings and all taxes of foreign subsidiaries into common pools, so that only a blended rate of foreign tax may be claimed as a foreign tax credit.

The benefit of the foreign tax credit is reduced for dividends received from foreign corporations that, in the hands of the recipient, benefit from reduced rates of tax in the U.S. A portion of foreign dividends received by U.S. individuals that qualify for the 0%, 15%, or 20% tax rate under Code §1(h)(11)(B)(i) are removed from the numerator and denominator of the foreign tax credit limitation to reflect the reduced tax rate.[4] This treatment reduces the foreign tax credit limitation when a U.S.-resident individual receives both qualifying dividends from a foreign corporation and other items of foreign-source income within the same basket that are subject to ordinary tax rates.

As a result, a U.S.-based group must determine the portion of its overall taxable income that is derived from foreign sources, the portion derived in each "foreign tax credit basket," and the portion derived from sources in the U.S. This is not an easy task, and in some respects, the rules do not achieve an equitable result from management's viewpoint.

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[3] Section 904(a) of the Internal Revenue Code of 1986.

[4] See Code §§1(h)(11)(C)(iv) and 904(b)(2)(B).

ALLOCATION AND APPORTIONMENT REGULATIONS AND SELF-HELP OPTIONS

U.S. income tax regulations require expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.[5] The allocation and apportionment procedures set forth in the regulations are exhaustive and tend to maximize the apportionment of expenses to foreign-source income. For example, all interest expense of the U.S. parent corporation and the U.S. members of its affiliated group must be allocated and apportioned under a set of rules that allocates interest expense on an asset-based basis to all income of the group. Direct tracing of interest expense to income derived from a particular asset is permitted in only limited circumstances. Research and development expenses, stewardship expenses, charitable deductions, and state franchise taxes also must be allocated and apportioned. These rules tend to reduce the amount of foreign-source taxable income in a particular category and may even eliminate that category altogether. The problem is worsened by carryovers of an overall foreign loss account.[6] This is an "off-book" account that arises when expenses incurred in a particular prior year are allocable and apportionable to foreign-source income and those expenses exceed the amount of foreign-source gross income of the year. Where that occurs, the loss is carried over to future years and reduces the foreign-source taxable income of the subsequent year.

The pressure that has been placed on full use of the foreign tax credit by a U.S.-based group has resulted in several public companies undergoing inversion transactions. In these transactions, shares of the U.S. parent company that are held by the public are exchanged for comparable shares of a newly formed offshore company to which foreign subsidiaries are eventually transferred. While the share exchange and the transfer of assets may be taxable events, the identity of the shareholder group (*i.e.*, foreign persons or pension plans) or the market value of the shares (*i.e.*, shares trading at relatively low values) may eliminate actual tax exposure in the U.S. Thereafter, the foreign subsidiaries are owned directly or indirectly by a foreign parent corporation organized in a tax-favored jurisdiction and the foreign tax credit problems disappear.

ANTI-INVERSION RULES

This form of "self-help" is no longer available as a result of the inversion rules of Code §7874. In some circumstances, Code §7874 imposes tax on inversion gains and that tax cannot be reduced by credits or net operating loss carryforwards. In other circumstances, Code §7874 treats the foreign corporation as if it were a U.S. corporation. In Notice 2014-52, the I.R.S. described regulations it intends to issue that will address transactions structured to avoid the purposes of Code §§7874 (involving inversion transactions), 367 (involving reorganizations or spin-offs), and 956 (investments in U.S. property by a C.F.C.).

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[5] See §§1.861-8 through 17 of the Income Tax Regulations.

[6] Section 904(f) of the Internal Revenue Code of 1986.

"In May 2015, the Treasury Department released for public comment draft updates to the U.S. Model Income Tax Convention."

- Regarding Code §7874, the regulations will disregard certain stock of a foreign acquiring corporation that holds a significant amount of passive assets. The potential abuse is that because the passive assets reflect an asset-stuffing transaction in the acquiring company, it has the effect of avoiding the triggers for the application of the anti-inversion provisions.
- Also regarding Code §7874, the regulations will provide guidance on the treatment of certain transfers of stock of a foreign acquiring corporation through a spin-off or otherwise that occur after an acquisition.
- Regarding Code §§7874 and 367, the regulations will provide guidance for disregarding certain distributions that are not made in the ordinary course of businesses. Again, because the potential abuse is that the distribution reduces the assets in the U.S. entity, it has the effect of avoiding the triggers for the application of the anti-inversion provisions.
- Regarding Code §956, the regulations will prevent the avoidance of the investment in U.S. property rules when a C.F.C. acquires obligations of or equity investments in the new foreign parent corporation or certain foreign affiliates.
- Regarding Code §956, the regulations will target the investment of pre-inversion earnings and profits of a C.F.C. through a post-inversion transaction that terminates the C.F.C. status of foreign subsidiaries or that substantially dilutes a U.S. shareholders' interest in those earnings and profits.
- Finally, regarding Code §956, the regulations will limit the ability of a group to remove untaxed foreign earnings and profits of C.F.C.'s through related party stock sales subject to Code §304 (which converts a stock sale of controlled stock into a dividend payment).

In May 2015, the Treasury Department released for public comment draft updates to the U.S. Model Income Tax Convention (the "U.S. Model"), which serves as the basic document that the U.S. submits when negotiating an income tax treaty. Among other things, the draft provisions propose to reduce the tax benefits that may be enjoyed by an expatriated group by imposing full withholding taxes on key payments such as dividends, interest, and royalties made by "expatriated entities" as defined under the Internal Revenue Code. This goes to the heart of the bargain between the U.S. and its treaty partners, because the full withholding tax reduces the tax in the country of the recipient.

FAVORABLE TAX BENEFITS THROUGH PROPER USE OF HOLDING COMPANIES

In this universe, the combination of foreign taxes imposed on the income earned by a subsidiary and the withholding taxes imposed on the distribution of dividends may generate foreign tax credits in excess of the foreign tax credit limitation. Dividend withholding taxes represent true costs for the offshore parent company, because of its location in a tax-favored jurisdiction. Intelligent use of a holding company structure may eliminate or reduce the withholding tax imposed on the distribution of

foreign profits. To illustrate, most countries impose a withholding tax on dividends paid to foreign persons. Historically, the rate was often in the range of 25% to 30% when treaty relief was not available and reduced to as little as 5% – in some instances nil – when a subsidiary paid a dividend to its parent corporation resident in a treaty jurisdiction. Other dividends are often subject to withholding tax of 15% under a treaty. Dividend withholding tax is eliminated entirely in the case of dividends paid from a subsidiary resident in the E.U. to a parent company that is also resident in the E.U., assuming that no abuse is viewed to be present in the corporate structure. If the U.S. does not have an income tax treaty in place with a particular foreign country, dividends paid by a subsidiary resident in that country may be reduced or eliminated if the dividend is paid to a holding company located in a favorable jurisdiction. A jurisdiction is favorable if the withholding tax paid on dividends received by the holding company and the withholding tax imposed on dividends paid by the holding company are low or nil and relatively little income tax is paid on the receipt of intercompany dividends or on gains from the disposition of shares of a subsidiary.

For multinational groups held by fiscally transparent entities in the U.S., such as L.L.C.'s, the maximum rate of U.S. tax for non-corporate members, such as individuals and nongrantor trusts, is 20%. In addition, dividends or inclusions of income under Subpart F or the P.F.I.C. rules are subject to the U.S. "net investment income tax."[7] The tax is imposed at the rate of 3.8% on the net investment income, or if lower, the excess of the individual's modified adjusted gross income[8] over a threshold amount varying from $125,000 to $200,000, depending on the individual's filing status. Net investment income consists of certain passive income reduced by allocable deductions. Passive income includes gross income from dividends. It also includes passive income in the form of interest, annuities, royalties, rents, and other gross income if the gross income is derived either from a trade or business in which the U.S. individual does not materially participate or from a trade or business of trading in financial instruments or commodities. Net investment income also includes net gain attributable to the disposition of property held in one of those two types of trade or business activities. Regulations address the application of the 3.8% tax in the case of U.S. individual shareholders in C.F.C.'s or Passive Foreign Investment Companies by providing that the tax may be imposed either at the time of the income inclusion or a subsequent time when cash is received.[9]

In the European context, many countries have tax laws that provide favorable income tax treatment for intercompany dividends paid across borders. Among these countries are Luxembourg, Denmark, Switzerland, England, Belgium, Spain, Cyprus, and the Netherlands. In Ireland, the tax rate is extremely low for trading profits of Irish corporations. Dividends received by Irish corporations out of earnings of foreign subsidiaries that arise from trading activities may be exempt from tax. The rules in place cause these jurisdictions to be popular locations for the formation of a holding company by a U.S.-based group. Often, however, these countries have other provisions that may be considered less favorable to a holding company. Capital

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[7] Code §1411.

[8] Modified adjusted gross income is the individual's adjusted gross income increased (if applicable) by the excess of the individual's foreign earned income over the deductions, exclusions, or credits, including foreign tax credits, allocable to the foreign-earned income and not allowed as a deduction in calculating adjusted gross income. Code §1411(d).

[9] Treas. Reg. §1.1411-10.

tax imposed on the issuance of shares and stamp tax on the transfer of shares are examples of unfavorable provisions. Other countries that have certain favorable features include Austria, France, and Germany, although none is typically thought of as a holding company location.

EUROPEAN ATTACKS ON CROSS-BORDER HOLDING COMPANIES AND TAX PLANNING

Tax benefits claimed by holding companies in Europe are now regularly challenged by the tax authorities in the European countries where the paying companies are resident. The challenges are directed at the substance of the holding company. Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management that is involved in day-to-day decision-making. In some instances, the capital structure of the holding company is queried. For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than tax residence in a particular country – it should conduct group functions in that country and be ready to provide evidence of the activities performed. These challenges within Europe should be compared with the approach to substance that is found in the limitation on benefits articles of U.S. income tax treaties. Objective standards are often provided under which substance is judged. In addition, active business activities of a group member can be attributed to related parties. In particular, the active trade or business provision of most limitation on benefits articles allows intermediary holding companies to be viewed as active participants in a business if they own at least 50% of a subsidiary or a partnership that has active business operations. These provisions eliminate intra-European challenges of tax authorities and may incenti*vize* direct investment.

Substance is also a key concern in the report on base erosion and profit shifting ("B.E.P.S.") published by the Organization for Economic Cooperation and Development ("the O.E.C.D."),[10] The report was commissioned by the G-20. It concludes that data in several studies indicates an increased disparity between (a) the location of actual business activities and investment and (b) the jurisdiction where the resulting profits are reported for tax purposes.

The report sets out how current cross-border taxation rules may create B.E.P.S. opportunities, thereby resulting in a reduction of the share of profits associated with substantive operations. It also emphasizes how changes in global business practices are ahead of current international tax standards, with a special focus on intangibles and the digital economy. The report identifies (i) a need for increased transparency on the effective tax rates of multinational enterprises and (ii) the existence of key pressure areas as far as B.E.P.S. is concerned. They include (i) international mismatches in entity and instrument characterization, (ii) application of treaty concepts to profits derived from the delivery of digital goods and services, (iii) the tax treatment of related party debt-financing, (iv) captive insurance and other intra-group financial transactions, (v) certain aspects of generally recognized transfer pricing rules, (v) the effectiveness of anti-avoidance measures, and (vi) the availability of harmful preferential regimes.

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[10] "Addressing Base Erosion and Profit Shifting," Organization for Economic Co-operation and Development, February 12, 2013.

The report concludes that a set of comprehensive, global, internationally-coordinated action plans should be developed and adopted by O.E.C.D. member countries and G-20 non-member countries to effectively address the identified problem areas. The O.E.C.D. governments are particularly committed to the development of proposals to implement this action plan. Many U.S.-based multinational groups fear that the proposals will overturn arm's length principles that have been recognized internationally for many years.[11]

While the B.E.P.S. report has no legal authority, it indicates how the issue could be addressed in examinations by tax authorities in Europe and in legislation already in the pipeline in several countries. Consequently, the B.E.P.S. report must be considered before setting up a foreign holding company, with particular attention being given to the three tax planning structures identified in the report.[12] To illustrate, in a press release dated June 20, 2014, regarding a meeting of the Council of Economic and Finance Ministers ("E.C.O.F.I.N."), an agreement was announced in the Parent-Subsidiary Directive designed to eliminate the exemption enjoyed by parent companies for dividends paid by subsidiaries when the subsidiary claims a deduction for the payment.

The B.E.P.S. report reflects a view that is now generally accepted by tax authorities on a global basis. Taxation should not be viewed as an expense. Rather, it reflects a partnership profit-sharing arrangement between governments and businesses. When schemes with no substance are followed to deprive the governments of their "profit share," businesses may conclude that proper tax planning practices have been followed for the benefit of their investors and governments may conclude that they are the victims of theft.

"Tax benefits claimed by holding companies in Europe are now regularly challenged by the tax authorities in the European countries where the paying companies are resident."

Also at issue are attacks on cross-border transactions that arise within the E.U. In particular, challenges have been raised based on concepts of state aid, transparency, and common reporting standards proposed by the European Commission. At surface level, tax planning has rarely been viewed to be an item of unfair state aid that violates basic rules of the E.U. That is about to change, as mechanisms directed at combatting unfair financial support are being aimed at multinational groups with regard to transactions in prior years. This initiative will be supplemented by information reporting designed to promote pan-European information exchange, both as to bank balances and "sweetheart" tax rulings.

PATH FORWARD

The balance of this paper examines challenges now faced by tax planners and the tax treatment of holding companies in each of the foregoing jurisdictions. The goal is to determine whether the country provides tax treatment – alone or in conjunction with a second jurisdiction – that makes the formation of a holding company attractive to a U.S.-based group of companies. Of course, in today's world, the tax benefits must be seen as non-abusive; if not, the anticipated tax benefit may be ephemeral.

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[11] Declaration on Base Erosion and Profit Shifting, Meeting of the OECD Council at Ministerial Level, Paris, May 29-30, 2013.

[12] "Addressing Base Erosion and Profit Shifting," Annex C – Examples of MNE's tax planning structures, Organization for Economic Cooperation and Development, February 12, 2013.

B.E.P.S. AND HOLDING COMPANIES

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BACKGROUND

B.E.P.S. is the acronym for today's most conceptually dense international tax reform proposal. Behind this acronym is the hidden meaning of Base Erosion and Profit Shifting. This project, bearing the appearance of a mythological monster for some, represents the dawn of a better system of international tax justice for others, especially academics and tax authorities. The source of this project arises from the meeting of government finance ministers and central bank governors from 20 major economies (the "G-20") in Moscow in 2013. The accompanying *communiqué*[1] pointed out that globalization had damaged many states' core sovereignty, which is to say, their capacity to legitimately levy a compulsory tax on income produced by their residents. As observed later in 2013 by the Organization for Economic Cooperation and Development ("O.E.C.D."), the interaction of independent sets of rules enforced by sovereign countries creates friction, including potential double taxation for corporations operating in several countries, but it can also create gaps in cases where corporate income is not taxed at all, either by the country of source or the country of residence, or is only taxed at nominal rates.[2] If the development of bilateral tax treaties can solve the problem of double taxation, it is clear that gaps still remain at present. Recent cases of tax evasion by large multinational enterprises ("M.N.E.'s"), as well as the international financial crisis, made states eager to stop such base erosion and profits shifting practices, and citizens have become more sensitive to tax fairness issues.

Consequently, the G-20 mandated that the O.E.C.D. develop an action plan addressing the B.E.P.S. issues and proposing solutions. In particular, it was intended that the action plan should provide states with domestic and international instruments to address these anticompetitive practices by M.N.E.'s around the world and to restore a form of legitimacy in the source of taxation.

The author would like to acknowledge the contributions of Alexandra Clouté and Elodie Schmidt, also of Arendt & Medernach, in the preparation of this article.

B.E.P.S. ACTION PLAN

On July 19, 2013, the O.E.C.D. published an Action Plan[3] addressing the perceived flaws in the international tax rules and transfer pricing rules, which were previously studied in a report released in February 2013.[4] This Action Plan proposed 15 measures to combat various forms of B.E.P.S. Adding to the February report, this Action Plan identifies the elements of concern against double non-taxation or low taxation and proposes concrete actions with deadlines to address them.

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1 *Communiqué* of February 16, 2013.

2 O.E.C.D. (July 19, 2013), "Action plan on Base Erosion and Profit Shifting," O.E.C.D. Publishing.

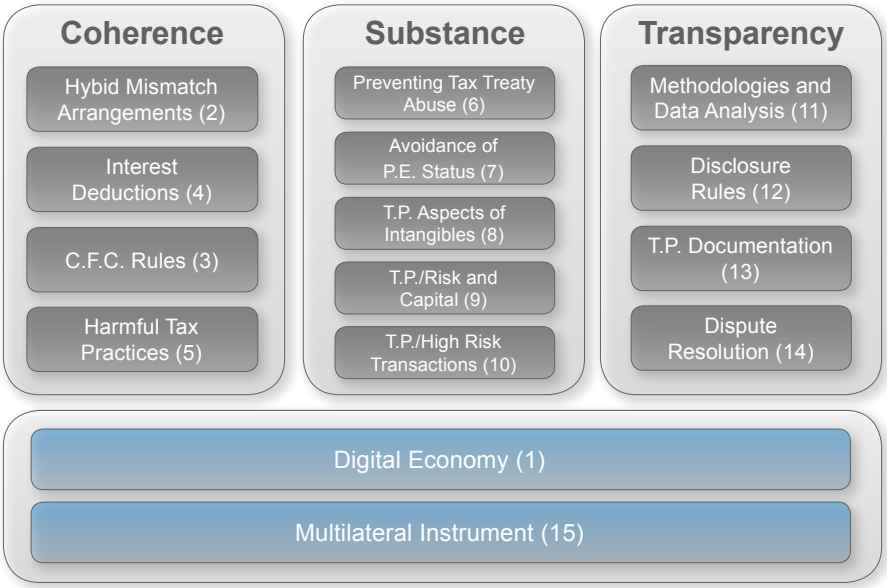
3 *Ibid*.

4 O.E.C.D. (2013), "Addressing Base Erosion and Profit Shifting," O.E.C.D. Publishing.

These Actions are organized around three main pillars:

- Coherence of corporate tax at the international level,
- Substance and realignment of taxation, and
- Transparency coupled with certainty and predictability.

Aside from those pillars, the Action Plan also calls for redressing harmful practices in the digital economy and for the development of a multilateral instrument to implement the measures developed.



Overall, the Action Plan sets out how current cross-border taxation rules may create base erosion and profit shifting opportunities, thereby resulting in a reduction of tax.

The O.E.C.D. Committee on Fiscal Affairs adopted a first set of seven reports and recommendations as an initial response to the 15 measures of the Action Plan. This work, published on September 16, 2014, reflected a view that different stakeholders needed to participate. Developing countries and other non-member economies of the O.E.C.D. or G-20 were consulted in numerous meetings and forums. In addition, business representatives, trade unions, banks, academics, and civil society organizations were given the opportunity to express themselves by commenting on discussion papers published by the O.E.C.D.

The published reports mainly dealt with the following Action Plan items:

- Tax challenges of the digital economy (Action 1);
- Hybrid mismatches in entity and instrument characterization (Action 2);
- Harmful tax practices (Action 5);
- Preventing treaty abuse (Action 6);
- Transfer pricing and intangibles (Action 8);

- Country-by-country reporting and transfer pricing documentation (Action 13);
- Use of multilateral instruments (Action 15).

These reports have been endorsed unanimously by the members of the G-20 during their September 2014 meeting. A further set of recommendations should be released in October 2015 with respect to the following:

- Strengthening controlled foreign company ("C.F.C.") rules (Action 3);
- Limiting base erosion via interest deductions and other financial payments (Action 4);
- Countering harmful tax practices (Action 5);
- Preventing the artificial avoidance of permanent establishment ("P.E.") status (Action 7);
- Assuring that transfer pricing outcomes are in line with value creation (Action 9-10);
- Establishing methodologies to collect and analyze data on B.E.P.S. (Action 11);
- Requiring taxpayers to disclose aggressive tax planning arrangements (Action 12); and
- Making dispute resolution more effective (Action 14).

"O.E.C.D. Actions related to B.E.P.S. demonstrate the passage from a system highlighted by individual competition among states for the greater good of one state to a system of international cooperation."

Scheduled for December 2015, a final set of recommendations will complement the existing O.E.C.D. recommendations on Action 4, Action 5, and Action 15, to ensure that all outstanding technical issues have been addressed after the October 2015 deliverables.

REFLECTING A SEA CHANGE IN ACCEPTABLE TAX PLANNING

The O.E.C.D. Actions related to B.E.P.S. demonstrate the passage from a system highlighted by individual competition among states for the greater good of one state to a system of international cooperation that reflects fiscal harmony contrary to abusive practices by economic operators. The more cynical might say that the change is one in which smaller economies that lived off arrangements that reduced tax in other countries will be required to reshape their economies to focus on more productive endeavors.

In calling for an international coordinated response, the B.E.P.S. project requires support from each state at the domestic level. Each state retains its fiscal sovereignty and is free to apply the measures proposed by the O.E.C.D. on different terms, as long as it does not go against its international legal commitments. Thus, an adjustment period may be required in order to renegotiate tax treaties or to amend domestic law. At the same time, the O.E.C.D. is developing a mandate to call for an international conference, which will develop a multilateral convention to amend the network of existing bilateral tax treaties all at one time.

Even though the B.E.P.S. report has no binding legal authority, it reflects a global consensus as to best practices, and for that reason, it may be relied on by tax authorities when challenging certain transactions or arrangements as abusive. Consequently, the real impact of B.E.P.S. may already exist, even if national measures have not yet been implemented fully.

EFFECTS ON HOLDING COMPANY STRUCTURES

In this respect, M.N.E.'s that use single purpose holding companies in global structures should be mindful of the B.E.P.S. reports. The ground rules under which plans were proposed and implemented in the past may not provide useful guidance in the future.

As of the writing of this article, B.E.P.S. measures remain in the drafting phase, with only the 2014 deliverables released. Thus, at this time, only an analysis of Action 2, Action 5, and Action 6 can be undertaken with regard to the effects on holding company structures. Other Actions for which the recommendations are scheduled for release in the second half of 2015 may be mentioned, but more in-depth analysis must be deferred.

B.E.P.S ACTION 2: HYBRID MISMATCH

Focus

Action 2 of the O.E.C.D. Action plan focuses on hybrid mismatch arrangements frequently used by holding companies. The principle of such arrangements is to exploit differences in the taxation of financial instruments or entities between two or more countries. In other words, the differences in the tax treatment under two or more tax jurisdictions can produce a mismatch in tax outcomes that have the effect of reducing or eliminating the aggregate tax burden of the parties to the arrangement.

In the September 2014 report, two basic mismatched tax outcomes are distinguished:

- An outcome involving a deduction in one country with no inclusion of income in another country ("D./N.I."), and
- A double deduction outcome in which one payment is deductible in two or more jurisdictions while the income is taxed only once or not at all ("D.D.").

Another version of the D./N.I. outcome was addressed under which a stranger to an intercompany transaction is imported into the arrangement to obtain a deduction that offsets unrelated income. This is the so-called "imported mismatch arrangement" and involves the use of a plain vanilla financial instrument that benefits the unrelated party.

Illustrative Fact Patterns

For the purpose of this section and due to the broad scope of Action 2, only a few examples of hybrid mismatch arrangements will be presented. Typical hybrid mismatches that lead to a D./N.I. outcome are illustrated by structures involving hybrid

financial instruments. The instrument is treated as debt in the issuer's country of residence and as equity in the holder's country. The issuer of the instrument treats its payment as deductible interest and the payee/holder treats the payment as a tax-exempt dividend.

Another example of hybrid mismatch can be found in arrangements with payment to reverse hybrid entities. Such entities are treated as tax transparent in one jurisdiction and as opaque in another. To illustrate, a company that is resident in Country A owns all of the shares in a subsidiary resident in Country B and was formed under the laws of Country B. The subsidiary is tax transparent under Country B's laws but is regarded as a separate taxable entity under the laws of Country A. Company C, residing in Country C, borrows money from the subsidiary and makes an interest payment under the loan. The payment is deductible under Country C's tax law but is not included in income under the laws of either Country A or B. Each of those countries treats the income as being derived by a resident of the other jurisdiction.[5]

"In order to combat each of these hybrid mismatch outcomes, the report provides two sets of recommendations. One provides recommendations for domestic tax, and the other provides recommendations for changes to the O.E.C.D. Model Tax Convention."

A third example of a hybrid mismatch transaction involves the payment made by a hybrid entity. In this scenario, the payer is usually tax transparent under the law of the jurisdiction of its parent or investor, but not in its own jurisdiction. To illustrate, Company A, a resident in Country A, owns all of the shares in Company B, a resident in Country B. Under the laws of Country A, Company B is viewed to be a branch of Company A. The tax transparent subsidiary borrows from Company A and pays interest on the loan. The loan is ignored under the laws of Company A. Because Company B is the parent of a consolidated group in Country B, the interest paid to Company A gives rise to a deduction that reduces the income of the Company B group. Nonetheless, there is neither income nor tax in Country A because the loan and the interest are treated as an internal transaction that is disregarded for purposes of Country A law.

Recommended Action

In order to combat each of these hybrid mismatch outcomes, the report provides two sets of recommendations. One provides recommendations for domestic tax, and the other provides recommendations for changes to the O.E.C.D. Model Tax Convention.

With respect to the domestic rules, the report recommends a denial of deductions in the country of the payor of the interest as the primary rule and the imposition of tax in the country of the recipient as a secondary rule if the primary rule is not adopted in the relevant country. In practice, when two jurisdictions are involved in a hybrid mismatch arrangement, the primary rule should determine which of the two jurisdictions ensures that tax is collected. In the event the jurisdiction of the payor has not yet introduced relevant hybrid mismatch legislation, the jurisdiction of the recipient should be entitled to rely on the secondary rule to neutralize the mismatch.

Additionally, the report recommends improving C.F.C. rules and the limitation of the tax transparency of reverse hybrids. In addition, the report advocates the implementation of rules that will adjust the tax outcome in one jurisdiction and align them with tax consequences in another.

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[5] O.E.C.D. (2014), "Neutralising the Effects of Hybrid Mismatch Arrangements," O.E.C.D./G-20 Base Erosion & Profit Shifting Project, O.E.C.D. Publishing.

As to treaty language, the report sets out a range of recommendations for changes to the O.E.C.D. Model Tax Convention to ensure that hybrid instruments and entities (as well as dual-resident entities) are not used to obtain the benefits of treaties unduly. It is suggested that a new provision and detailed commentary should be included to ensure that the income of transparent entities is treated, for the purposes of the Convention, in accordance with the new international standards.

B.E.P.S. ACTION 4: INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

Focus

Action 4 focuses on the need to address base erosion and profit shifting using deductible payments, such as interest, that can give rise to double non-taxation in both inbound and outbound investment scenarios.[6]

- The fact patterns deemed to be abusive are those that allow the use of:
- Intragroup loans to generate deductible expenses in a high tax jurisdiction and taxable interest income in low tax jurisdictions,
- Interest deductions on loans that finance assets that produce exempt income or income recognized on a deferred basis,
- Hybrid mismatches between jurisdictions generating interest deductions but no taxation of income, and
- A disproportionate level of third-party debt incurred by companies located in high tax jurisdictions compared to the group overall debt.

Recommended Action

A draft report published in December 2014 offers three alternatives to address these situations of base erosion and profit shifting. Following comments from stakeholders and tax officials on this draft,[7] the final recommendations on the solutions are scheduled for release in October 2015.

The first alternative in the draft report is to limit interest deductions for each group member to its actual net third-party interest expense and that, within a group, all interest expense should match the economic activity of the company incurring the debt. A second alternative would be to limit the interest deduction with reference to a fixed ratio. An entity would be able to deduct interest expenses up to a specified proportion of its earnings, assets, or equity as determined by each state. A final alternative would result in a combined approach.

The comments to the draft were negative, and it is expected that the O.E.C.D. may move away from its position. As of the date of this article, the final resolution remains unknown.

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[6] O.E.C.D. (2014), "Discussion draft on Action 4 (Interest deductions and other financial payments)."

[7] O.E.C.D. (2015), "Public comments received on discussion draft on Action 4 (Interest Deductions and Other Financial Payments) of the BEPS Action Plan."

B.E.P.S. ACTION 5: HARMFUL TAX PRACTICE

Focus

Another B.E.P.S. Action substantially affecting holding companies is the portion of Action 5 that is intended to "counter harmful tax practices more effectively, taking into account transparency and substance." Previous O.E.C.D. publications, such as the O.E.C.D.'s 1998 report Harmful Tax Competition: An Emerging Global Issue,[8] show that the topic has been discussed for many years among the different stakeholders. Action 5 proposes to reorganize the existing material gathered by the Forum on Harmful Tax Practices (the "Forum") with regard to aggressive benefits granted to cross-border transactions by various countries in their respective domestic tax laws.

Illustrative Fact Patterns

Here is a typical argument and organization used by an M.N.E. when investing in Intellectual Property ("I.P.") through a jurisdiction offering an attractive I.P. regime.

A multinational group holding I.P. rights has its seat located in a jurisdiction that has no favorable tax regime for I.P. holders. No tax incentives are available to reduce income from license fees and royalties generated by the exploitation of these I.P. rights. The M.N.E. will be taxable on the income arising from the exploitation of its I.P. at ordinary corporate income tax rates.

To address the situation, the M.N.E.'s managers interpose a company ("IPCo") located in a jurisdiction that has laws providing a more favorable I.P. regime ("the other jurisdiction"). The I.P. rights are held by IPCo, and it receives royalties from other group members for the use of the I.P. These royalties are fully deductible by group members utilizing the I.P. but are fully or partially exempt when IPCo computes its tax under the laws of the other jurisdiction. The group uses the accumulated funds within IPCo through intercompany loans that give rise to interest expense that is fully deductible by group members without being subject to withholding tax.

Recommended Action

In September 2014, a first report[9] on Action 5 was published. In broad terms, Action 5 aims at tackling any corporate arrangements benefiting from disproportionate tax advantages in a given jurisdiction. It requires that corporate substance and activity should be in line with taxation and that tax transparency should be enhanced through the exchange of rulings related to low tax schemes.

The work already performed by the Forum with respect to the substance requirements was focused principally on I.P. regimes. Although other advantageous tax regimes have been scrutinized, the I.P. regime will be the only regime addressed in this section.

As mentioned in the report and in the *Agreement on Modified Nexus Approach for IP*

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[8] O.E.C.D. (1998), "Harmful Tax Competition: An Emerging Global Issue," O.E.C.D. Publishing.

[9] O.E.C.D. (2014), "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance," O.E.C.D./G-20 Base Erosion & Profit Shifting Project, O.E.C.D. Publishing.

Regimes[10] published at the beginning of 2015, the nexus approach is the approach selected to impose substantial activities for preferential I.P. regimes. The nexus approach enables a taxpayer to benefit from an I.P. regime if it has itself performed the research and development that usually give rise to the I.P. income. The nexus approach recommends that M.N.E.'s adjust their operational substance activity so that the tax benefit from the regime is closely tied to the economic reality of operations.

"The nexus approach enables a taxpayer to benefit from an I.P. regime if it has itself performed the research and development that usually give rise to the I.P. income."

As part of the nexus approach, it has been agreed that countries offering I.P. regimes will be required to undertake changes so that no harmful tax incentives are granted after June 30, 2016. Companies currently enjoying I.P. regimes that would no longer be eligible under the new international standards should benefit from a five-year grandfathering period.

In the above example, the direct consequence of Action 5 will be that IPCo will be taxed at full corporate rates in the other jurisdiction on its royalty and license fee income after completion of the five-year grandfather period, unless it fully staffs the company with personnel performing research and development activity. The other jurisdiction may provide tax and other incentives that are not considered harmful under Action 5. While the scope of acceptable incentives is not yet known, jurisdictions that have already developed a reduced tax regime for I.P. should be able to develop a new regime that meets the standard of Action 5.

The second milestone of Action 5 is the improvement of transparency including the mandatory exchange of rulings regarding low tax schemes. With regard to transparency, the work of the Forum follows a two-step approach. The first step aims to develop a framework for compulsory spontaneous information exchange on rulings, while the second step focuses on the application of this framework, including a review of ruling regimes in force in O.E.C.D. and associated countries. This is not unlike the regime that has been adopted within the E.U. already, as discussed elsewhere in this article.

The framework of the mandatory spontaneous information exchange on rulings is defined on the basis of four main questions:

- When does the obligation to exchange information arise?
- To whom should the information be sent?
- What kind of information should be communicated?
- How will the obligation to exchange information be implemented?

Some further indications are provided in this part of Action 5 with respect to the procedure to follow in cases of exchange of information on rulings (*i.e.*, reciprocity, timing, confidentiality, etc.).

Without being able to determine the perfect timing of implementation in the O.E.C.D. and various associated countries or the exact consequences of the substance activity requirements and the framework for transparency, M.N.E.'s benefiting from an advantageous holding regime should attempt to anticipate these changes by reviewing their tax planning strategies in light of the new reality. More guidance and

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[10] O.E.C.D. (2015), "Action 5: Agreement on Modified Nexus Approach for IP Regimes," O.E.C.D./G-20 Base Erosion & Profit Shifting Project, O.E.C.D. Publishing.

work on the implementation should be included in the forthcoming October 2015 report.

B.E.P.S. ACTION 6: PREVENT TREATY ABUSE

Focus

As mentioned in the introduction to this article, holding companies may be used as a tool for tax planning and treaty shopping. Treaty shopping normally involves a resident of a country gaining access to a tax treaty between two other states either through a conduit company or by any other arrangements in circumstances where the resident would not have been otherwise able to claim a comparable benefit in order to reduce its overall taxable burden.

In order to combat this practice, the O.E.C.D. has amended its commentaries related to the Model Convention regarding beneficial ownership requirements in connection with Articles 10 (Dividends), 11 (Interest), and 12 (Royalties). Nevertheless, the efficiency of these measures is now being questioned by Action 6 of the B.E.P.S. project.

The B.E.P.S. Action Plan has identified treaty abuse, and in particular treaty shopping, as one of the most important sources of base erosion and profit shifting. In its deliverable presented on September 16, 2014, the O.E.C.D. makes a distinction between two types of treaty abuse:

- Abuse of the tax treaty itself, and
- Abuse of domestic tax law by using treaty benefits.

Recommended Action

In order to address treaty shopping arrangements, the O.E.C.D. recommends a treaty-based solution implying the following amendments to the model convention:

- Inclusion in the title and preamble of tax treaties of a clear statement that the contracting states, when entering into a treaty, intend to avoid creating opportunities for non-taxation or reduced taxation;
- Inclusion in tax treaties of a specific anti-abuse rule based on the limitation-on-benefits ("L.O.B.") provisions, as is provided in treaties concluded by the United States and a few other countries; and
- Addition to tax treaties of a more general anti-abuse rule ("G.A.A.R") based on the principal purpose test ("P.P.T.") in order to address other forms of treaty abuse.[11]

"The L.O.B. clause provides a relatively objective basis for establishing a nexus between treaty benefits and entities having a relationship with the resident country."

The L.O.B. clause provides a relatively objective basis for establishing a nexus between treaty benefits and entities having a relationship with the resident country. However, some commentators pointed out that collective investment vehicles ("C.I.V.'s") and non-C.I.V. funds would not qualify under the L.O.B rules, as they

[11] O.E.C.D. (2014), "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, action 6," O.E.C.D./G-20 Base Erosion & Profit Shifting Project, O.E.C.D. Publishing.

do not meet any of the proposed requirements. Regarding their particular activity, discussions are still taking place to determine whether these funds should qualify per se under the L.O.B. provisions or whether a genuine diversity of ownership test should apply under which each investor must meet an L.O.B. test separately.[12]

Since the L.O.B. clause might not catch all "conduit arrangements," a G.A.A.R provision should be included in future tax treaties to deny benefits "if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit."[13]

As pointed out by commentators, the scope of this rule could lead to legal uncertainties. In particular, holding and financing activities, even though constituting genuine business activities, may fall within this scope.[14]

In addition, the wording of the G.A.A.R. provision raises issues with regard to E.U. law since it targets arrangements where "one of the principal purposes" is the intention to obtain the treaty benefits. The proposed P.P.T. rule may therefore be considered too extensive with respect to E.U. fundamental freedoms. The European Court of Justice has stated:

> [A] national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.[15]

The second type of abuse analyzed by Action 6 addresses situations where treaties prevent the application of specific domestic laws targeting abuses such as domestic G.A.A.R., thin-capitalization rules, C.F.C. rules, and similar provisions. Action 6 introduces in tax treaties a "saving-clause" that confirms the Contracting States' right to tax their residents according to their domestic law, notwithstanding the provisions of the treaty. As the O.E.C.D. pointed out, such a provision could clearly lead to double-taxation situations in which the only solution offered by the recommendations is to invite states to resort to the mutual agreement procedure.

On November 21, 2014, the O.E.C.D. published a new discussion draft on Action 6 identifying 20 issues on which follow-up work is necessary. In the light of the public comments received in response, a revised discussion draft was published on May 22, 2015, which in particular presents an alternative "simplified" L.O.B. rule.[16]

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12 O.E.C.D. (2015), "Revised discussion draft, BEPS Action 6: prevent treaty abuse," O.E.C.D. Publishing.

13 O.E.C.D. (2014), "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, action 6," O.E.C.D./G-20 Base Erosion & Profit Shifting Project, O.E.C.D. Publishing.

14 Olivier R. Hoor and Pierre Kreemer (May 2014), "The O.E.C.D. Discussion Draft on BEPS Action 6 (Prevent treaty abuse): a critical analysis," AGEFI Luxembourg.

15 E.C.J., September 12, 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*.

16 O.E.C.D. (2015), "Revised discussion draft, BEPS Action 6: prevent treaty abuse," O.E.C.D. Publishing.

This alternative version of the L.O.B. clause would address the most obvious cases of treaty shopping and would be accompanied by a P.P.T. provision in order to meet a minimum standard of protection required by the 2014 deliverable.

At this stage, all proposed provisions in connection with Action 6 that amend the O.E.C.D. Model Tax Convention are in draft forms and are still subject to improvement. A release in final form is scheduled for September 2015.

STATE AID, TRANSPARENCY MEASURES, AND REPORTING STANDARDS IN THE E.U.

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INTRODUCTION

Because the E.U. Member States are free to decide on their economic policy and direct taxes are not harmonized among the E.U. Member States, there is a strong tax competition within the E.U. market. In order to ensure a level playing field with respect to direct taxation, several initiatives have been taken in this context at the E.U. level. Currently, the discussion focuses on the key issues of state aid, transparency measures, and reporting standards.

STATE AID

Legal Framework and Definition of "State Aid"

Pursuant to Article 107 sec. 1 of the Treaty on the Function of the European Union ("T.F.E.U."), any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings is incompatible with the internal market, insofar as it affects the trade between the Member States. A measure qualifies as "State Aid" if the following prerequisites are met:

- The relevant intervention must be granted by a Member State or through State resources.[1]
- The intervention provides an economic advantage to the recipient.[2]
- The intervention affects or may affect competition and trade between the Member States.[3]
- The advantage is selective, *i.e.*, it is only granted to specific recipients.[4]

Even if a measure fulfills the aforementioned prerequisites of State Aid within the meaning of Article 107 sec. 1 T.F.E.U., it might not be unlawful if one of the exemptions provided in Article 107 sec. 2 or sec. 3 T.F.E.U. applies.

For example, State Aid having a social character and being granted to individual consumers, State Aid eliminating damages caused by natural disasters, or specific State Aid in relation to the former division of the Federal Republic of Germany are

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1 Commission notice of November 11, 1998 on the application of State aid rules to measures relating to direct business taxation, Official Journal C 384, December 10, 1998, p. 3 par. 10.

2 *Ibid*., p. 3 par. 9.

3 *Ibid*., p. 3 par. 11.

4 *Jestaed* in Heidenhain, European State Aid Law, 2010, §8 par. 9.

compatible with the internal market.[5] In addition, the following may be considered being compatible with the internal market:[6]

- Aid to promote the economic development of certain areas,[7]
- Aid promoting the execution of projects of common interest or to remedy serious disturbances in the economy[8] of a Member State,[9]
- Aid to facilitate the development of certain economic activities or areas without affecting the trading conditions,[10]
- Measures promoting culture and heritage conservations without affecting trading conditions and competition,[11] and
- Other categories of aid specified by decision of the Counsel on proposal from the Commission.[12]

Article 108 Sec. 3 T.F.E.U. provides that if a Member State intends to implement a new State Aid measure, it must notify the Commission. Furthermore, pursuant to Article 108 Sec. 1 T.F.E.U., existing State Aid measures are constantly reviewed by the Commission. However, the T.F.E.U. contains neither detailed provisions regarding the notification procedure nor detailed provisions regarding the review of existing State Aid or the recovery of unlawful State Aid. But Article 109 T.F.E.U. authorizes the Council (on proposal from the Commission and after consulting the Parliament) to implement any appropriate regulation regarding the application of the State Aid provisions which the Council utilized to adopt the Council Regulation (EU) No. 734/2013[13] ("Procedural Regulation").

Pursuant to the Procedural Regulation, the Commission decides whether a notified measure constituting State Aid is compatible with the internal market.[14] Prior to the Commission's authorization, notified State Aid should not be put into effect.[15] If the Commission finds that an existing State Aid is incompatible with the internal market, it decides whether the Member State granting the State Aid should amend or abolish the respective measure within a period of time determined by the Commission.[16] In this case, State Aid must be recovered from the beneficiary.[17]

"National provisions regarding direct business taxation may be considered as State Aid if the definitional prerequisites of the T.F.E.U. are met."

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5 T.F.E.U., article 107 sec. 2.

6 *Ibid*.

7 *Ibid*., sec. 3 lit a.

8 In particular, this exemption was of importance in context with the financial crises, *Blumenberg/Kring*, IFSt Nr. 473, 2011, 21(f).

9 T.F.E.U., article 107 sec. 3 lit b.

10 *Ibid*., lit c.

11 *Ibid*., lit d.

12 *Ibid*., lit e.

13 Council Regulation 734/2013/E.U. of July 22, 2013 amending Regulation 659/1999/E.C. laying down detailed rules for the application of Article 93 of the E.C. Treaty, Official Journal L 204, July 31, 2013, p. 15.

14 *Ibid*., article 7.

15 *Ibid*., article 2 sec. 2.

16 T.F.E.U., article 108 sec. 2 sentence 1.

17 Council Regulation 734/2013/E.U, article 14 sec. 1.

Application of State Aid Rules to Direct Business Taxation

The principle of incompatibility of State Aid with the internal market applies to aid "in any form whatsoever."[18] As a consequence, national provisions regarding direct business taxation may be considered as State Aid if the definitional prerequisites of the T.F.E.U. are met. In 1998, the Commission clarified these prerequisites with respect to national tax provisions and adopted the Commission Notice on the application of State Aid rules to measures relating to direct business taxation.[19]

Economic Benefit

According to the Commission's notice, a tax measure grants an economic benefit within the meaning of Article 107 sec. 1 T.F.E.U. if it relieves the beneficiary of charges he normally has to bear. This advantage could be provided by a reduction in the tax base, for instance by special deductions or depreciations or the setting up of reserves in the balance sheet. Tax exemptions, tax credits, deferred payment of taxes, and the cancellation of tax debt are examples of economic benefits that could also be considered as an advantage.[20]

Benefit Through State Resources

With respect to taxes, this economic benefit is provided through State resources if the tax measure results in a loss of tax revenue, because the reduced tax revenue is equivalent to fiscal expenditures funded from State resources.[21] This applies even if the tax State Aid might have an indirect positive overall effect on budget revenue.[22] Furthermore, the State support may not just be provided by legislation but also through the practices of the tax authorities.[23]

Negative Impact on Trade and Competition

Tax measures affect trade and competition if the beneficiary carries on an economic activity that also involves trade between the Member States and if the State Aid strengthens the beneficiary's position in relation to its competitors.[24]

Selectivity

The most complex question in the context of State Aid and direct business taxation is whether a tax measure qualifies as selective.

Provisions regarding direct business taxation are selective if only certain undertakings are favored. This is not the case if the scope of a tax provision covers all undertakings in a Member State and if all these undertakings have effective access to the respective provision, since the scope of the tax measure is not reduced byway of

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18 Commission notice of November 11, 1998, p. 3 par. 2.

19 Official Journal C 384, December 10, 1998.

20 Commission notice of November 11, 1998, p. 3, par. 9.

21 *Ibid*., par. 10.

22 E.C. Commission report of February 9, 2004 on the implementation of the Commission notice on the application of state aid rules to measures relating to direct business taxation (C(2004)434), par. 19.

23 Commission notice of November 11, 1998, p. 3 par. 10.

24 *Ibid*., par. 11.

discretionary decisions or similar factors.[25] Pursuant to this principle, the determination of tax rates, depreciation rules, and rules regarding tax loss carried forward do not constitute State Aid[26] due to their equal application to all economic participants in a Member State. Even the fact that those generally applicable tax incentives may provide a relatively higher benefit to some undertakings does not automatically cause a tax measure to be State Aid.[27]

In comparison, a decisive factor is whether an identified tax measure is an exception to the application of a Member State's general tax system. Therefore, the determination of selectivity requires a multistage test. As a first step, the tax system in issue and the deviation from the standard provision must be identified. Then, a determination must be made whether the deviation is justified "by the nature or the general scheme" of the tax system.[28]

"The most complex question in the context of State Aid and direct business taxation is whether a tax measure qualifies as selective."

The meaning of this provision and the interpretation of its prerequisites is unclear and there is no official guidance on the way the "nature" or the "general scheme" of a tax system is identified.[29] Moreover, no consensus exists among scholars in legal literature on how to define the tax system in issue. According to the Commission, a justification "by the nature or the general scheme" might be considered if the deviation derives "directly from the basic or guiding principles of the tax system."[30] Since the Commission replaces one ambiguous term with another vague description, only the case law provides guidance with regard to the justification.

With respect to the nature or the general scheme of an identified tax system, the Commission holds, for example, that progressive tax rates are justified by the redistributive purposes of income taxes or the exemption of non-profit organizations, *i.e.*, foundations or associations are justified by the fact that only income is subject to tax within the income tax system.[31] Anyway, the Member States are required to provide the Commission with reasons for the application of the justification for the deviations[32] during the notification procedure or the examination of potentially unlawful State Aid.

Recovery of Unlawful State Aid

If an existing tax provision comprises State Aid within the meaning of Article 107 sec. 1 T.F.E.U. and if no exemption within the scope of Article 107 sec. 2 or sec. 3 T.F.E.U. applies, the Member State is obliged, upon a decision of the Commission, to recover the unlawful State Aid from the beneficiary.

The Commission may only refrain from its decision regarding the recovery in two defined cases. If the recovery of unlawful State Aid is contrary to a general principle of the Community law, no recovery will be required (Article 14 sec. 1 sent. 2 Procedural

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25 *Ibid*., par. 13.

26 *Ibid*., par. 13.

27 *Ibid*., par. 14.

28 *Ibid*., par. 16.

29 *Jestaed*, §8 par. 19.

30 Commission notice of November 11, 1998, p. 3 par. 16.

31 *Ibid*., par. 24, 25.

32 *Ibid*., par. 23.

Regulation). Those general principals provide for an exemption if, for instance, the recovery is absolutely impossible[33] or the protection of legitimate expectation[34] refuses the revocation. These exemptions are rarely applicable. Further, the recovery of unlawful State Aid is subject to a limitation period of ten years (Article 15 sec. 1 Procedural Regulation).

Apart from theses exceptions and pursuant to Article 14 sec. 1 Procedural Regulation, Member States must take all necessary measures to recover the unlawful State Aid from the beneficiary, including interest on the deferred payment.[35] The recovery must be executed immediately and is subject to the national law of the concerned Member State, provided that its national provisions allow the immediate and effective execution of the recovery.

According to case law of the E.C.J., the national procedural law has to be interpreted in such a way that it does not negatively affect the enforcement of Community law (Supremacy of Community law).[36] Therefore, national rules providing that an administrative decision is un-appealable after expiring the limitation period[37] or the suspending effect of an action against the recovery decision are not applicable to the refund of unlawful State Aid.[38]

"Targets of these investigations include aid to (i) Apple granted by Ireland, (ii) Starbucks granted by the Netherlands, and (iii) Fiat granted by Luxembourg."

Illustrative Examples

In the past few years, tax provisions have been subject to an increasingly rigorous scrutiny as to whether they represent State Aid. Investigations in the context of international business taxation suggest that the Commission views aggressive tax planning and tax base erosion by large multinationals as examples of State Aid.[39] The targets of these investigations include aid to (i) Apple granted by Ireland,[40] (ii) Starbucks granted by the Netherlands,[41] and (iii) Fiat granted by Luxembourg.[42]

In these cases, the Commission opened investigations to examine whether tax authorities granted significant tax reductions by way of tax rulings confirming transfer pricing arrangements. These rulings qualify as State Aid if the calculation of intercompany prices does not comply with market terms and therefore implies a benefit for the company by allowing it, but not its competitors, to allocate profits to low tax jurisdictions.[43]

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33 *Sinnaeve* in Heidenhain, European State Aid Law, 2010, §32 par. 26.

34 *Ibid*., par. 24.

35 Council Regulation 734/2013/E.U., article 14 sec. 2.

36 E.C.J., C - 24/95, March 20, 1997, European Court Reports 1997, I-1591.

37 *Ibid*., par. 38.

38 E.C.J., C - 232/05,October 5, 2006, European Court Reports 2006, I-10071.

39 European Commission, Press Release, June 11, 2014, IP/14/663.

40 State aid SA.38373 (2014/C) (ex 2014/NN) – Alleged aid to Apple, Official Journal C 369, October 17, 2014, p. 22.

41 State aid SA.38374 (214/C) (ex 2014/NN) (ex 2014/CP) – Alleged aid to Starbucks, Official Journal, C 460, December 19, 2014, p. 11.

42 State aid SA.38375 (2014/C) (ex 2014/NN) – Alleged aid to FFT, Official Journal C 369, October 17, 2014, p. 37.

43 State aid SA.38373, p. 22 par. 53; European Commission, Press Release, June

In the case of Apple, for example, the Commission argues that the transfer prices were negotiated rather than substantiated by reference to comparable market transactions and therefore the ruling does not reflect the arm's length principle under appropriate guidance for transfer pricing.[44] A similar argument based on a deviation from the arm's length principle has been raised regarding Ireland because it grants a selective benefit to Apple by way of lowering its total tax burden.[45]

Another example is the in-depth investigations initiated by the Commission regarding the Belgian excess profit ruling system in 2015.[46] Pursuant to the respective national tax regulations, a company's tax burden can be reduced by so called "excess profits," which are registered in the accounts of the Belgian entity allegedly resulting from the advantage of being part of a multinational group.[47] The Commission has concern whether this scheme favors members of multinational groups compared to their stand-alone competitors acting in Belgium and that the benefits resulting from this scheme overestimate general advantages of being part of a multinational group.[48]

TRANSPARENCY MEASURES

The aforementioned rigorous State Aid proceedings illustrate that not only the O.E.C.D., with its work on the B.E.P.S. project, but also the E.U. is engaged in the discussion of combatting base erosion and profit shifting. However, State Aid investigations are not the only tool in this context. The current discussion also focuses on transparency and the broadening of those transparency measures.

Current Measures

Currently, Directive 2011/16/E.U.,[49] as amended by Directive 2014/107/E.U.,[50] ("Administrative Cooperation Directive") lays down the provisions for the cooperation of the Member States in relation to the exchange of information that might be relevant to the administration of domestic tax law. Pursuant to this Directive, the Member States are obliged to share information that is foreseeably relevant regarding the administration of all taxes (except for V.A.T. and customs duties)[51] of a Member State in three different situations.

The tax authorities of a Member State must communicate information regarding taxable periods from January 1, 2014 that is available concerning residents in another Member State relating to income from:

11, 2014, IP/14/663.

44 State aid SA.38373, p. 22 par. 58.

45 *Ibid*., par. 69, 70.

46 European Commission, Press Release, February 3, 2015, IP/15/4080.

47 *Ibid*.

48 *Ibid*.

49 Directive 2011/16/E.U. of February 15, 2011, Official Journal L 64/1, March 11, 2011.

50 Directive 2014/107/E.U. of December 9, 2014 amending Directive 2011/16/E.U. as regards mandatory automatic exchange of information in the field of taxation, Official Journal L 359/1, December 16, 2014.

51 Directive 2011/16/E.U., article 2 sec. 2.

- Employment,
- Director's fees,
- Life insurances,
- Pensions, and
- The ownership of and income from immovable property (mandatory automatic exchange of information).[52]

Directive 2014/107/E.U. significantly expanded the scope of information that must be transmitted on a mandatory basis. Pursuant to the amended Administrative Cooperation Directive, Member States must communicate personal data with respect to custodial and depository accounts and the account balance as of the end of a calendar year and the total gross amount of interest, dividends, and gains from the disposal of financial assets credited to the concerned account.[53]

In addition, Member States must spontaneously communicate information in several expanded circumstances:

- The Member State supposes that there may be losses of tax in another Member State.
- A tax exemption or reduction in one Member State might give rise to an increasing tax liability in another Member State.
- Business dealings between two persons are conducted in a way that might result in tax savings.
- The tax authority of a Member State supposes that tax savings may result from artificial transfer or profits between groups of enterprises.
- Information forwarded to a Member State has enabled information to be obtained which might be relevant for taxation in the other Member State (spontaneous exchange of information).[54]

At least, Member States must exchange information on taxes that might be relevant to another Member State upon request of the other Member State (exchange of information on request).[55]

Tax Transparency Package

As part of its efforts to tackle corporate income tax avoidance and harmful tax competition in the E.U.,[56] and certainly as a reaction to the State Aid investigations resulting from tax rulings to multinationals discussed above,[57] the Commission presented a package of tax transparency measures in March 2015.

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52 *Ibid*., article 8 sec. 1.

53 *Ibid*., article 8 sec. 3a, as amended by Directive 2014/107/E.U.

54 *Ibid*., article 9 sec. 1.

55 *Ibid*., article 5.

56 European Commission, Press Release, March 18, 2015, IP/15/4610.

57 See **Illustrative Examples**, above.

Transparency on Tax Rulings

Information regarding cross-border tax rulings is currently only transmitted pursuant to the spontaneous exchange of information scheme[58] of the Administrative Cooperation Directive. Because these provisions are interpreted by each Member State in accordance with its standard (*e.g.*, the Member State which forwards information regarding a tax ruling decides whether the information to be forwarded is "relevant" or not and could therefore avoid sharing the information), the Commission considers the existing provision to be insufficient.[59] According to the Commission, practical experience illustrates that very little information is exchanged between the Member States regarding tax rulings or transfer pricing agreements ("A.P.A.").[60]

"As a key element of its transparency package...would require countries to transmit information on national tax rulings to other Member States that may be affected by these rulings on a mandatory basis."

As a key element of its transparency package, the Commission announced the proposal of a directive[61] that would require countries to transmit information on national tax rulings to other Member States that may be affected by these rulings on a mandatory basis. To implement the automatic and mandatory exchange of information, the Commission proposes to amend the Administrative Cooperation Directive by a new Art. 8a.

Pursuant to the new provision, Member States issuing or amending a cross-border tax ruling or an A.P.A. after the date of entry into force of the amended Administrative Cooperation Directive will automatically communicate information to the competent authorities of all other Member States as well as to the Commission.[62] Member States will also communicate information on tax rulings and agreements issued within a period of ten years prior to the entry into force of the amended directive, provided those rulings remain valid.[63] At a minimum, the information to be shared with other Member States must include all of the following items:

- The identification of the taxpayer (and the group of companies to which it belongs),
- The content of the tax ruling or A.P.A. with a description of the relevant activities or transactions of the taxpayer,
- A description of the criteria used for determining the transfer prices in the case of an A.P.A., and
- The identification of the other Member States and of any legal entity likely to be directly or indirectly affected by the tax ruling or A.P.A.[64]

In addition to the mandatory transmission of information, Member States may request additional information including the full text of the tax ruling or A.P.A.[65] This

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58 See **Current Measures**, above.

59 European Commission, Press Release, March 18, 2015, IP/15/4610; European Commission, Fact Sheet, March 18, 2015, MEMO/15/4609.

60 Proposal for a Council Directive amending Directive 2011/16/E.U. as regards mandatory automatic exchange of information in the field of taxation, COM(2015) 135/2, p. 3.

61 *Ibid*.

62 *Ibid*., p. 3 art. 1 sec. 3.

63 *Ibid*.

64 *Ibid*.

65 *Ibid*.

provision is based on the principle that the Member State receiving information regarding tax rulings is most qualified to assess the potential impact and relevance of such rulings on its domestic tax law.[66]

Further Transparency Initiatives

The package presented by the Commission in March 2015 contains several proposals for further measures to improve tax transparency.

In one proposal, the Commission suggests for consideration the adoption of additional transparency requirements for multinational companies. These additional requirements would oblige multinationals to disclose a limited set of tax information to the public. Extending disclosure requirements is designed to increase public scrutiny and awareness of the multinational's tax practices. This initiative requires further analysis of benefits, costs, data protection, etc.[67]

In the past, the Code of Conduct on Business Taxation[68] has been a helpful tool in fighting harmful tax regimes. But modern tax incentives such as patent boxes have shown that the criteria in the Code of Conduct have become inadequate. The Commission proposes to update the Code of Conduct.[69]

Because precise figures on tax evasion and corporate tax avoidance are not available, the Commission proposes to work with Eurostat, the statistical office of the E.U., and the Member States on compiling reliable data on the scale and economic impact of tax evasion and tax avoidance. The goal is to better target policy measures to better measure the success of future proposals through a reliable benchmark system.[70]

With the amended Administrative Cooperation Directive, the Member States have committed to a mandatory automatic exchange of information on financial information for tax purposes.[71] Since provisions previously contained in the Savings Tax Directive[72] are now covered by the Administrative Cooperation Directive, the Commission proposed to streamline the legal framework by repealing the Savings Tax Directive.[73]

COMMON REPORTING STANDARDS

Regarding reporting standards, the E.U. legal framework distinguishes between listed companies on the one hand and companies in the legal form of limited liability companies or limited partnerships.

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66 *Ibid*., p. 2.

67 Communication from the Commission to the European Parliament and the Council on tax transparency to fight tax evasion and avoidance, COM(2015) 136, p. 5.

68 Official Journal C 2/1, January 6, 1998.

69 COM(2015) 136, p. 6.

70 *Ibid*.

71 See **Current Measures**, above.

72 Official Journal L 111/50, April 15, 2014.

73 COM(2015) 136, p. 5.

With respect to listed companies, Regulation E.C. 1606/2002[74] as amended by Regulation E.C. 297/2008[75] allows the Commission the authority to adopt the International Financial Reporting Standards ("I.F.R.S."), the International Accounting Standards ("I.A.S."), and the related Interpretations ("S.I.C./I.F.R.I.C.-Interpretations") issued by the International Accounting Standards Board ("I.A.S.B.").[76] On this legal basis, the Commission adopted the aforementioned international financial reporting standards by issuing a Commission regulation (the "I.A.S. Regulation").[77] As a result, the international financial reporting standards are directly applicable in the domestic legislation of all Member States. If the I.A.S.B. issues new or amended standards or interpretations, the adoption of these new provisions follows a complex endorsement process.[78] Therefore, the I.A.S. Regulation is amended continuously.

Besides the international financial reporting standards, further reporting requirements for listed companies arise from the Transparency Directive[79] and the Prospectus Directive:[80]

- Pursuant to the Transparency Directive, issuers are required to inform the public market periodically about their financial statements and their management report.[81]
- Pursuant to the Transparency Directive, shareholders of listed companies are subject to reporting obligations if their voting rights exceed or fall below defined thresholds as a result of an acquisition or a disposal of shares.[82]
- Pursuant to the Prospectus Directive, issuers of securities offered to the public are obliged to publish a comprehensive prospectus reporting information concerning the issuer and the securities to be offered.[83]

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74 Official Journal L 243/11, September 11, 2002.

75 Official Journal L 97/62, April 9, 2008.

76 Regulation 1606/2002/E.C. of the European Parliament and of the Council of July 19, 2002 on the application of international accounting standards, Official Journal L 243/11, September 19, 2002, articles 2, 3 sec. 1.

77 Commission Regulation 1126/2008/E.C. of November 3, 2008 adopting certain international accounting standards in accordance with Regulation 1606/2002/E.C.

78 For further details regarding the endorsement see Regulation 1606/2002/E.C., article 6; and Council Decision 1999/468/E.C. of June 28, 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission, Official Journal L 184, July 17, 1999, articles 5a, 8.

79 Directive 2008/22/E.C. of the European Parliament and of the Council of March 11, 2008 amending Directive 2004/109/E.C. on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, as regards the implementing powers conferred on the Commission, Official Journal L 76/50, March 19, 2008.

80 Directive 2003/71/E.C. of the European Parliament and of the Council of November 4, 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/E.C., Official Journal L 345, December 31, 2003.

81 Directive 2008/22/E.C., chapter II.

82 Directive 2008/22/E.C., chapter III.

83 Directive 2003/71/E.C., article 5.

Companies in the legal form of limited liability companies or in the legal form of partnerships, whose partners have limited liability, fall in the scope of the Accounting Directive.[84] The Accounting Directive requires these entities to present their annual financial reports in compliance with general principles set forth in the directive. For this purpose, the directive broadly defines general provisions regarding balance sheets, profit and loss accounts, notes to the financial statements, and management reports, as well as regarding the publication and disclosure of this information and auditing of financial statements. With respect to small- and medium-sized companies, the Member States may apply optional exemptions to the regulatory requirements of the Accounting Directive to avoid excessive demands of those undertakings. The Member States are obliged to bring into force the laws and provisions necessary to comply with the Accounting Directive by July 20, 2015.[85]

In addition, a recently issued directive requires large groups to report non-financial and diversity information. For this purpose, the respective companies will be obliged to publish information to the extent necessary for an understanding of the undertaking's development, performance, position, and impact of its activity, relating to environmental, social, and employee matters, respect for human rights, and anti-corruption and bribery matters.[86] The Member States must transfer these provisions into domestic law by December 6, 2016.[87]

CONCLUSION

It is clear that over recent years, the major economic democracies in Europe have attempted to retake control of their "tax" borders by forcing companies resident in E.U. Member States and the E.U. Member States, themselves, to operate in a totally transparent environment. By shining a light on tax planning and rulings, the Commission hopes to obtain a level playing field for all Member States regarding tax policy. While these steps do not amount to a common set of tax rules that will apply across Europe, they likely will reduce opportunities to gain benefit through divergent tax treatment in two or more jurisdictions.

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84 Directive 2013/34/E.U. of the European Parliament and of the Council of June 26 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/E.C. of the European Parliament and of the Council and repealing Council Directives 78/660/E.E.C. and 83/349/E.E.C., Official Journal L 182/19, June 19, 2013.

85 Directive 2013/34/E.U., article 53 sec. 1.

86 Article 4 sec. 1 Directive 2014/95/E.U. of the European Parliament and of the Council of October 22, 2014 amending Directive 2013/34/E.U. as regards the disclosure of non-financial and diversity information by certain large undertakings and groups, Official Journal L 330/1, November 15, 2014.

87 *Ibid*.

LUXEMBOURG

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Over the last decades, Luxembourg has been extremely popular as a holding and financing jurisdiction for both E.U. and non-E.U. investors. Its position as an important financial center and the professional environment it is able to offer combined with advantageous tax treatment and corporate flexibilities give Luxembourg a leading role as a preferred European jurisdiction for holding, financing, and private wealth management activities. More recently, Luxembourg has also adopted favorable measures to stimulate investments in family wealth investment platforms and to further enhance its position with respect to regulated and non-regulated investment funds.

A variety of Luxembourg entities are suitable for holding and investment activities.

A taxable Luxembourg holding company, which in French is often referred to as a "*Société de Participations Financières*" or a "S.O.P.A.R.F.I.," is an attractive vehicle to serve as a group holding company or investment platform. A S.O.P.A.R.F.I. is a normal commercial company that may carry out any activities falling within the scope of its corporate purpose clause. A S.O.P.A.R.F.I. may take the form of, *inter alia*, a Société Anonyme ("S.A.," a public limited company), a *Société à Responsabilité Limitée* ("S.à r.l.," a limited liability company), or a *Société en Commandite par Actions* ("S.C.A.," a partnership limited by shares). As such, a S.O.P.A.R.F.I. is fully subject to Luxembourg income tax and net worth taxes. Profit distributions by a S.O.P.A.R.F.I. are in principle subject to Luxembourg dividend tax. Considering that a S.O.P.A.R.F.I. is fully subject to Luxembourg income tax, it is entitled to the benefits of the tax treaties concluded between Luxembourg and other countries and the E.U. tax directives.

Among international tax practitioners, the acronym "S.O.P.A.R.F.I." was historically often used to distinguish a regular Luxembourg company that was used as a holding company from (i) a so-called 1929 Holding Company, which was abolished in 2006, or (ii) a "*Société de Gestion de Patrimoine Familial*" regime ("S.P.F."), which was introduced in May 2007. The S.P.F. is fully exempt from Luxembourg corporate income and withholding taxes, but it is not eligible for protection under the Luxembourg bilateral tax treaties or the E.U. tax directives.

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Besides the S.O.P.A.R.F.I. and the various investment fund platforms, Luxembourg law provides for two collective investment vehicles.

First, a regime applies to investments in risk-bearing capital (*e.g.*, venture capital and private equity), namely the "*Société d'Investissements en Capital à Risque*" ("S.I.C.A.R."). Under certain circumstances, the S.I.C.A.R. can also be used as a tax efficient investment holding company.

Second, a legal and regulatory framework applies to securitization vehicles ("*Sociétés de Titrisation*") coupled with a favorable tax regime. The S.I.C.A.R. and the securitization vehicles will be dealt with in the final paragraphs of this chapter.

GENERAL/PARTICIPATION EXEMPTION

A S.O.P.A.R.F.I. established in the city of Luxembourg is subject to Luxembourg income tax at a combined top rate of 29.22% as of January 1, 2014 and January 1, 2015 (*i.e.*, national corporate income tax, plus municipal business tax, plus a 7% surcharge for an unemployment fund).

"In July and December 2014, the E.C.O.F.I.N. adopted amendments to the Parent-Subsidiary Directive to include provisions countering hybrid loan arrangements and implementing a general anti-abuse rule."

A S.O.P.A.R.F.I. is subject to a fixed minimum amount of corporate income tax. Companies subject to this minimum tax are defined as collective entities having their statutory seat or their central administration in Luxembourg and having financial assets comprising at least 90% of its total balance sheet assets. The minimum tax amounts to €3,210 (including the 7% surcharge); collective entities whose total balance sheets do not exceed €350,000 are subject to a reduced minimum tax of €535. Losses carried forward remain in existence. If a S.O.P.A.R.F.I. is part of a Luxembourg fiscal unity, both the parent company and the subsidiaries' part of the fiscal unity are subject to the minimum tax. However, the aggregate minimum tax payable by a fiscal unity is capped at €21,400 (including the 7% surcharge). The parent company is liable for its own minimum tax as well as for the minimum tax of the subsidiaries' part of the fiscal unity.

The fixed minimum tax is considered an advance payment of corporate income tax due in future years, if and to the extent that the taxpayer incurs corporate income tax in future years. If no corporate income tax is incurred, the advance becomes a final tax payment. There is no time limit imposed on the use of minimum tax payments that are carried forward from earlier years. However, the balance available increases as years go by without the imposition of corporate income tax.

A S.O.P.A.R.F.I. may be entitled to the benefits of the Luxembourg participation exemption, which grants a 100% exemption for dividends and gains (including FX gains) realized from qualifying subsidiaries.

To the extent that the participation exemption is applied to exempt dividends derived from subsidiaries resident in an E.U. Member State, it reflects the implementation of the modified E.U. Parent-Subsidiary Directive (2011/96/EU), as amended from time to time (hereinafter: the "Parent-Subsidiary Directive"). In this respect, it is noted that in July[1] and December[2] 2014, the E.C.O.F.I.N. adopted amendments to the Parent-Subsidiary Directive to include provisions countering hybrid loan arrangements and implementing a general anti-abuse rule. The hybrid loan provisions aim at preventing double non-taxation via the use of hybrid financing arrangements, by limiting the exemption of payments received through such arrangements. The anti-abuse provision requires E.U. Member States to refrain from granting the benefits of the Parent-Subsidiary Directive (*i.e.*, withholding exemptions) to certain arrangements that are not "genuine." In addition, for the benefits of the Parent-Subsidiary Directive to be denied, one of the main purposes of the arrangement must be to obtain a tax advantage that would defeat the object or purpose of the Parent-Subsidiary Directive. Ultimately, E.U. Member States, including Luxembourg, must amend

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[1] Council Directive 2014/86/EU of July 8, 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[2] Proposal for a Council Directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States - Political agreement, COM(2013) 814 final.

their domestic laws in accordance with the revised Parent-Subsidiary Directive by January 1, 2016. The practical impact of these changes is to be monitored.

Dividends

According to Article 166 of the Luxembourg Income Tax Act ("I.T.A."), dividends (including liquidation dividends) received by a S.O.P.A.R.F.I. are exempt from Luxembourg income tax if the following requirements are met:

- The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax transparent entity), or the participation has an acquisition cost of at least €1.2 million;
- The subsidiary is a collective entity or a company with capital divided into shares and is (i) a fully taxable Luxembourg entity, (ii) an entity falling within the scope of Article 2 of the Parent-Subsidiary Directive or a permanent establishment thereof, or (iii) a company subject in its country of residence to a profit tax comparable to the Luxembourg corporate income tax in terms of rate and taxable basis (see below); and
- At the time of distribution, the S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, the participation for an uninterrupted period of at least 12 months, and during this period, its interest in the subsidiary may not drop below the threshold mentioned above (10% or an acquisition cost of €1.2 million).

The participation exemption applies on a per-shareholding basis. Consequently, dividends from newly acquired shares will immediately qualify for the participation exemption provided that the rules above are met (10% or an acquisition value of €1.2 million).

Capital Gains

According to the Grand-Ducal Decree of December 21, 2001 (as amended on December 21, 2007) on the application of Article 166 I.T.A., capital gains (including FX gains) realized by a S.O.P.A.R.F.I. upon the disposition of shares of a subsidiary are exempt from Luxembourg income tax if the following requirements are met:

- The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax transparent entity), or the participation has an acquisition cost of at least €6 million;
- The subsidiary is (i) a fully taxable Luxembourg entity, (ii) an entity falling within the scope of Article 2 of the Parent-Subsidiary Directive or to a permanent establishment thereof, or (iii) a company subject in its country of residence to a profit tax comparable to the Luxembourg corporate income tax in terms of rate and taxable basis (see below); and
- The S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, a minimum participation, as mentioned above, for an uninterrupted period of at least 12 months.

SUBJECT-TO-TAX

As outlined above, in order to qualify for the Luxembourg participation exemption on dividends and capital gains, nonresident subsidiaries that do not qualify under Article 2 of the Parent-Subsidiary Directive must be subject to a comparable tax in their country of residence.

Based on parliamentary documents, this requirement is to be understood as follows: A foreign corporate income tax is comparable if it is levied at a rate of at least 10.5% and the tax basis is computed on a basis that is similar to Luxembourg. No list of qualifying countries for this purpose exists. Where comparability is subject to doubt, an advance tax agreement ("A.T.A.") can be requested from the Luxembourg tax authorities.

Certain treaties concluded by Luxembourg contain a participation exemption for dividends in the treaty itself, even if no tax or limited tax is actually imposed. Therefore, by virtue of such treaties, dividends received from favorably taxed foreign companies, such as a Swiss finance company, should be exempt from tax at the S.O.P.A.R.F.I. level. In addition, the minimum ownership period requirement of a treaty is generally shorter than period required under Luxembourg law (*e.g.*, beginning of the accounting year versus 12 months).

"In order to qualify for the Luxembourg participation exemption on dividends and capital gains, nonresident subsidiaries...must be subject to a comparable tax in their country of residence"

DIVIDENDS/CAPITAL GAINS AFTER SHARE EXCHANGE

The Luxembourg I.T.A. provides for certain tax-free reorganizations. Such favorable tax treatment applies to:

i. Conversions of a loan whereby securities representing share capital of the debtor are issued to the creditor;

ii. Transformations of a capital company into another capital company whereby securities of the transformed company are issued to the shareholder;

iii. Mergers or divisions of capital companies or companies resident in an E.U. Member State whereby securities of the merged company are issued to the shareholder of the disappearing company; and

iv. Certain other mergers.

For the transaction to qualify as a tax-free reorganization, the acquisition date and cost of the transferred shares (or the book value of the converted loan in the case of i. above) must be carried over and continued in the commercial accounts on the shares received in exchange.

In the cases described (other than ii. above), the transaction remains tax-free even if cash is paid to the shareholder, provided that the cash does not exceed 10% of the nominal value of the shares.

During the five years following any of the foregoing transactions, income derived from a participation (*i.e.*, dividends and capital gains) received pursuant to the covered transaction does not fall within the scope of the participation exemption, if the transferred participation did not qualify for the participation exemption prior to the transaction.

LUXEMBOURG PERMANENT ESTABLISHMENT

The participation exemption also applies to dividends and gains on participations earned by, or attributed to, a Luxembourg permanent establishment of a resident of an E.U. Member State or of a Treaty Country. If the entity is a resident in a Treaty Country, it must be subject-to-tax (refer to the section **Subject-to-Tax** of this chapter above).

Partial Participation Exemption

An interest in a subsidiary of less than 10% with an acquisition cost of less than €1.2 million and/or an interest in a subsidiary for which the 12-month holding-period requirement is not and will not be met, will not qualify for the participation exemption described above. However, dividend income derived from such interests may nevertheless be eligible for a 50% exemption, provided that the other conditions for the participation exemption above are met.

Withholding Tax in a Foreign Subsidiary's Country

Dividends paid by a foreign subsidiary to a Luxembourg holding company and gains on alienation of the shares may be subject to withholding tax or capital gains tax. Such taxes may be eliminated or reduced pursuant to the Parent-Subsidiary Directive or a tax treaty concluded by Luxembourg and the foreign subsidiary's country of residence.

As of the date of this article, Luxembourg has 76 income tax treaties in force with the following countries:		
Armenia	Israel	Russia
Austria	Italy	San Marino
Azerbaijan	Japan	Saudi Arabia
Bahrain	Jersey	Seychelles
Barbados	Kazakhstan	Singapore
Belgium	Laos	Slovakia
Brazil	Latvia	Slovenia
Bulgaria	Liechtenstein	South Africa
Canada	Lithuania	South Korea
China	Macedonia	Spain
Czech Republic	Malaysia	Sri Lanka
Denmark	Malta	Sweden
Estonia	Mauritius	Switzerland
Finland	Mexico	Taiwan
France	Moldova	Tajikistan

Georgia	Monaco	Thailand
Germany	Mongolia*	Trinidad and Tobago
Greece	Morocco	Tunisia
Guernsey	Netherlands	Turkey
Hong Kong	Norway	United Arab Emirates
Hungary	Panama	United Kingdom
Iceland	Poland	United States
India	Portugal	Uruguay
Indonesia	Qatar	Uzbekistan
Ireland	Romania	Vietnam
Isle of Man		
*terminated by Mongolia		

Additionally, Luxembourg is in the process of ratifying 22 income tax treaties and seven more are under negotiation. Of those 29, five are protocols being negotiated and 24 are either new treaties or existing treaties being renegotiated.

DEDUCTION OF COSTS

Value Adjustments

A S.O.P.A.R.F.I. may make deductible value adjustments on a participation. The deductions can be used to offset other income (such as income from financing activities or commercial activities) and may result in tax losses. Losses may be carried forward indefinitely. However, the losses are recaptured in the event of a future disposition of the company. The capital gains exemption (as described above) does not apply to the extent of such previously deducted expenses and value adjustments. As a result, a capital gain arising from a disposition of shares may (in part) be taxable and offset by available losses carried forward.

The same applies to value adjustments of a receivable on the participation.

Financial Costs

Financing expenses connected with a participation are tax deductible to the extent that they exceed exempt income from such a participation in a given year. The deducted amount can be used to offset other types of income and capital gains resulting from a subsequent disposition of shares (subject to the recapture rule described above).

In principle, expenses are allocated on a historic direct-tracing basis. Where direct tracing is not possible, expenses are allocated on a *pro rata* basis (*e.g.*, based on the number of participations or the relative value of each).

Currency gains and losses on loans (to the extent realized) are taxable or deductible. Therefore, currency exposure should be avoided, preferably by denominating

such loans in Euro. Currency gains on the investment in the participation itself, or on repayments of issued share capital, are exempt by virtue of the participation exemption. Currency losses on the investment itself and on repayments of issued share capital are tax deductible but may fall under the recapture rules.

Liquidation Losses

A loss realized upon liquidation of a participation is deductible. Losses realized by a foreign permanent establishment of a Luxembourg resident company are, in principle, not deductible.

WITHHOLDING TAX ON OUTBOUND DIVIDENDS AND CAPITAL GAINS

Dividend Distributions

Dividends distributed by a S.O.P.A.R.F.I. are subject to Luxembourg dividend withholding tax at the rate of 15%, unless an exemption or a lower treaty rate applies. (See also below in respect of liquidation dividends.) Under Article 147 of the I.T.A., exemptions may apply for dividend distributions from a Luxembourg company to one of the following entities, if certain conditions are met:

- A fully taxable Luxembourg entity;
- An entity falling within the scope of Article 2 of the Parent-Subsidiary Directive, or a permanent establishment thereof;
- A Swiss resident capital company that is subject to corporation tax in Switzerland without benefiting from an exemption; or
- A company resident in a Treaty Country and subject in that country to a profit tax comparable to the C.I.T. in terms of rate and taxable basis.

Such distributions are exempt from Luxembourg dividend withholding tax if:

- The dividend is paid to a qualifying entity that holds 10% or more of the issued share capital of the Luxembourg company (which may be held via a tax transparent entity), or the participation has an acquisition cost of at least €1.2 million; and
- The qualifying entity has held, or commits itself to continue to hold, a minimum participation as mentioned above for an uninterrupted period of at least 12 months. (In recent practice, prior to the completion of the 12-month holding period, the fulfillment of this requirement must be guaranteed by way of a commitment letter from the shareholder.)

Tax transparent shareholders should be disregarded for the purpose of determining whether the above conditions are met.

As a result of the amended Parent-Subsidiary Directive, Luxembourg may need to amend the conditions for qualification for the exemption where the exemption is part of an arrangement set up “ingenuinely” to obtain a tax advantage that would defeat the object or purpose of the Parent-Subsidiary Directive.

Interest Payment on (Hybrid) Debt

Arm's length fixed or floating rate interest payments to Luxembourg and non-Luxembourg residents are not subject to Luxembourg withholding tax. However, interest paid on certain profit sharing bonds, and arguably, profit sharing interest paid on loans, is subject to 15% withholding tax, unless a lower tax treaty rate applies.

In connection with Directive 2003/48/EC on taxation of savings income in the form of interest payments (the "E.C. Savings Directive"), Luxembourg no longer withholds tax on certain savings income, as of January 1, 2015, but now automatically exchanges information with E.U. Member States on interest paid through a Luxembourg paying agent (usually a bank) to E.U. resident individuals or so-called "residual entities."

"Under certain conditions, hybrid debt instruments may be issued by a S.O.P.A.R.F.I."

Under certain conditions, hybrid debt instruments may be issued by a S.O.P.A.R.F.I. These hybrid debt instruments (*e.g.*, convertible preferred equity certificates commonly referred to as "C.P.E.C.'s") are normally treated as debt for Luxembourg legal, accounting, and tax purposes but may be treated as equity for tax purposes in the country of residence of the holder of the instrument (*e.g.*, the U.S.). The expression "C.P.E.C.'s" is often used as a general abbreviation. However, the precise terms and conditions may differ on a case-by-case basis.

In a European context, following the amendments made to the Parent-Subsidiary Directive (referred to in **General/Participation Exemption**, above) the use of hybrid instruments may be limited where two E.U. Member States are concerned. As a result of the amended Parent-Subsidiary Directive, Luxembourg may be expected to introduce legislation barring the deduction of interest paid on hybrid instruments issued by a Luxembourg company to an E.U. holder of such instruments. Such legislation would be effective as of January 1, 2016. There is no reason to assume that Luxembourg will – at the same time – extend such a deduction limitation to hybrid instruments issued to non-E.U. holders.

In addition, hybrid instruments are targeted by the O.E.C.D.'s work on base erosion and profit shifting ("B.E.P.S."). Action 2 of the B.E.P.S. Action Plan calls for treaty provisions and domestic rules to neutralize the effects of hybrid mismatch arrangements, through deduction limitations and a general anti-abuse rule.

CAPITAL GAINS IN HANDS OF SHAREHOLDERS

Resident individual shareholders are taxable on the alienation of shares (including by way of liquidation) in a S.O.P.A.R.F.I. where:

- The alienation, or (partial) liquidation of the shareholding, takes place within six months of acquisition (speculation gain); or
- The alienator owns, either directly or indirectly, a substantial interest in the S.O.P.A.R.F.I.

In very broad terms, a substantial interest exists if a shareholder either alone or together with certain close relatives has held a shareholding of more than 10% in a Luxembourg company at any time during the five-year period preceding the alienation.

Nonresident shareholders who do not have a Luxembourg permanent establishment to which shares and/or income or gains from shares in a S.O.P.A.R.F.I. should be attributed, are only subject to Luxembourg capital gains tax on the alienation of shares where such shareholders own a substantial interest, either directly or indirectly, and (i) the alienation or liquidation takes place within six months of acquisition (speculation gain) or (ii) in case of an alienation after six months the shareholders have been Luxembourg resident taxpayers for more than 15 years and have become non-Luxembourg resident taxpayers less than five years before the alienation. Note however, that Luxembourg, in general, will not be entitled to tax this gain under applicable tax treaties.

REPURCHASE OF SHARES IN A S.O.P.A.R.F.I.

In principle, by virtue of articles 146(1) and 97(1) of the I.T.A., a repurchase of shares in a S.O.P.A.R.F.I. is subject to Luxembourg dividend tax insofar as there are retained earnings available in the S.O.P.A.R.F.I. However, a repurchase by the company and subsequent cancellation of all shares from one or more shareholders, that cease to be shareholders, is considered to be a capital gain that is not subject to Luxembourg dividend tax (the so-called "partial liquidation").

OTHER TAX ISSUES

Debt/Equity Ratio

Luxembourg law does not contain any provisions regarding debt-to-equity ratios. Based on transfer pricing principles generally applied by the Luxembourg tax authorities, one should generally avoid a debt-to-equity ratio in excess of 85:15 for the financing of subsidiaries. If a higher ratio is maintained, a portion of the interest payments may be considered constructive dividends, which will not be deductible for Luxembourg corporate income tax purposes, and, depending on the case, a Luxembourg dividend withholding tax obligation may arise. Interest-free debt, in general, qualifies as equity for purposes of the 85:15 test.

Capital Duty

Luxembourg has no capital duty. Instead, a fixed registration duty of €75 applies to (i) the incorporation of a Luxembourg entity, (ii) an amendment to the bylaws of a Luxembourg entity, and (iii) the transfer of the statutory or actual seat of an entity to Luxembourg.

Annual Net Worth Tax

A S.O.P.A.R.F.I. is subject to an annual net worth tax, which is levied at the rate of 0.5% of the company's worldwide net worth on January 1 of each year. Certain assets are excluded, such as, intangible assets that qualify for the Luxembourg intellectual property regime.

Shares in a participation are also exempt provided that the participation exemption for dividend income, as described above in the section on **General/Participation Exemption**, is applicable. However, with regard to the net worth tax exemption there is no minimum holding period requirement.

A net worth tax obligation may, upon request, be reduced by the amount of corporate income tax payable (before other credits). The net worth tax may not, however, be credited against the minimum fixed corporate income tax described in **General/ Participation Exemption** and is further limited to the minimum tax that would have been due had the relevant taxpayer been subject to the minimum taxation rules. This limitation is subject to certain conditions, but it may be beneficial to a foreign parent company resident in a country that allows a credit for foreign income taxes but not for foreign net worth taxes, such as the United States. Previously, Luxembourg corporate income tax was reduced by the credit for the net worth tax. In such a case, the creditable amount of foreign taxes is technically reduced under Treas. Reg. §1.901-2(e)(4)(i).

Advance Tax Agreements and Advance Pricing Agreements

As of January 1, 2015, the procedure to obtain an advance tax agreement ("A.T.A.") has been codified into Luxembourg law. An A.T.A. confirms the tax authorities' interpretation of the tax law as applied to the specific facts of the case presented by the taxpayer. Following submission, an A.T.A. request will be reviewed by a committee that will advise the relevant tax inspector. Submission of a request is subject to a fee of up to €10,000 payable to the Luxembourg tax authorities.

An advance pricing agreement ("A.P.A.") confirming the arm's length character of the remuneration to be earned by a Luxembourg company on its intra-group financing activities can also be requested, subject to the same conditions. In addition, the financing company must have sufficient substance in Luxembourg and must effectively bear the risks related to the financing transactions for which the A.P.A. is being sought (*i.e.*, it must have equity at risk for its financing activity corresponding to at least 1% of the nominal value of the loans granted without exceeding €2 million).

"The European Commission is currently conducting an examination of the A.T.A. practices of various E.U. Member States, including Luxembourg."

The European Commission is currently conducting an examination of the A.T.A. practices of various E.U. Member States, including Luxembourg. In its preliminary findings on specific cases (referred to below), the European Commission has stated that an A.T.A. that merely confirms in advance the application of tax law in a particular case is legitimate. On the other hand, an A.T.A. that grants state aid is not allowed under the E.U. treaties. Under these rules, it is in general illegal for E.U. Member States to grant, on a selective basis, aid (including tax benefits) to undertakings. If illegal aid was granted, the European Commission can order the Member State involved to recover that aid from the beneficiary undertaking, with interest.

The European Commission is currently investigating A.T.A.'s issued to Amazon and F.F.T. in light of possible state aid aspects. Preliminary findings were published on October 17, 2014, regarding F.F.T. and on February 6, 2015, regarding Amazon. The European Commission is expected to release its final conclusions in June 2015. By June 8, 2015, final conclusions have not been released.

S.I.C.A.R.

Luxembourg has adopted the S.I.C.A.R. law, which provides for a flexible and tax-favorable regime for any investments in risk-bearing capital owned by a S.I.C.AR.-type vehicle. The purpose of this law is to facilitate private equity and venture capital investments within the E.U.

The S.I.C.A.R. can be incorporated in the form of a capital company, such as an

S.à r.l. or an S.A., or a transparent entity, such as an S.C.S. ("*Société en Commandite Simple*"). A S.I.C.A.R. is a regulated entity, though in a relatively light manner compared to investment funds, such as Undertakings for Collective Investments in Transferable Securities, ("U.C.I.T.S."). The S.I.C.A.R. is subject to prior approval and supervision by the *Commission de Surveillance de Secteur Financier* ("C.S.S.F."). At the same time, it benefits from flexible legal rules regarding investment in private equity and venture capital.

In principle, a S.I.C.A.R. is fully taxable for corporate income tax purposes. However, income realized in connection with its investments in risk-bearing capital is fully exempt from corporate income tax. Other income, such as interest accrued on bank deposits, management fees, and the like, is normally taxed. A S.I.C.A.R. is, in principle, entitled to the benefits of the Luxembourg tax treaties and the Parent-Subsidiary Directive. In addition, a S.I.C.A.R. is exempt from net worth tax and from withholding tax on dividend distributions. Nonresident investors in a S.I.C.A.R. are not subject to Luxembourg taxes on dividends distributed or capital gains realized on the disposal of the shares in a S.I.C.A.R. A S.I.C.A.R. is subject to the minimum tax rules, as described above in **General/Participation Exemption**.

SECURITIZATION VEHICLE

Luxembourg has also adopted an attractive legal, regulatory, and tax framework for securitization vehicles (the "S.V. Law").

The S.V. Law defines "securitization" very broadly as:

> The transaction by which a securitization vehicle acquires or assumes, directly or through another vehicle, the risks relating to claims, obligations, and other assets or to the activity of a third party by issuing securities the value or the yield of which depends on such risks.

A securitization vehicle can either be set up in the form of a capital company, such as an S.à r.l., S.A., S.C.A. or *Société Commerciale*, or in the form of a fund managed by a management company. Securitizations with Luxembourg special purpose vehicles outside the scope of the S.V. Law are also possible.

Securitization vehicles that issue securities to the public on a regular basis are subject to prior approval and supervision by the C.S.S.F. An issuance of securities to the public or continuous private placements, do not require prior approval. Securitization vehicles set up as funds are, as a general rule, subject to prior approval and supervision by the C.S.S.F.

The law offers flexibility and protection of investors' and creditors' rights and ensures bankruptcy remoteness of the securitization vehicle, by expressly confirming the effectiveness of "non-petition" and "non-attachment" clauses. In addition, the S.V. Law expressly allows for subordination provisions and validates the "true sales" character of the transfer of the securitized assets to the securitization vehicle. It also recognizes that investors' and creditors' rights and claims are limited in recourse to the securitized assets and enables the creation of separate compartments within a single securitization vehicle, each comprising a distinct pool of assets and liabilities.

Securitization vehicles are, in principle, fully subject to Luxembourg corporate

income tax at the standard combined rate of 29.22%. However, the securitization vehicle is able to deduct from its taxable base all "commitments" owed to investors and creditors. A commitment should be interpreted as including all payments, either in the form of interest or dividend, made by the securitization vehicle to its investors and creditors. The taxable result of the company could, therefore, be virtually reduced to nil, albeit that a securitization vehicle is subject to the minimum tax described in **General/Participation Exemption**. Securitization vehicles set up in the form of a fund are considered to be transparent for corporate income tax purposes.

Dividend distributions from a securitization vehicle are not subject to withholding tax, as such distributions are deemed to be interest payments. As a result, a Luxembourg normally taxable parent company is not entitled to the participation exemption with respect to dividends and capital gains realized in connection with a participation in a securitization company.

In a cross-border situation, the Luxembourg tax authorities take the position that the securitization company should be entitled to the benefit of withholding tax relief with respect to dividends sourced in a Treaty Country or in an E.U. Member State under the Parent-Subsidiary Directive. They also hold that dividends distributed by a securitization company to an E.U. qualifying parent company should be entitled to the participation exemption in the parent's E.U. Member State. This position is, however, not binding on the tax authorities of any other E.U. Member State or Treaty Country. Cross-border tax relief with respect to dividends received or distributed by a securitization company depends on the analysis made by the other E.U. Member States and Treaty Countries.

Securitization vehicles are exempt from net worth tax.

RECENT AND CURRENT DEVELOPMENTS

Transfer Pricing Regulation

To strengthen the transparency of Luxembourg transfer pricing legislation the arm's length principle has been codified in Article 56 of the I.T.A., as of January 1, 2015. The wording of the new provision is inspired by Article 9 of the O.E.C.D. Model Tax Convention. The new legislation stipulates that upon the request of the tax authorities, the taxpayer is obliged to present relevant information underlying the transfer prices agreed between associated enterprises.

Luxleaks

In November and December of 2014, a substantial number of rulings, approved by the Luxembourg tax authorities in the years 2002 to 2010, were leaked to the International Consortium of Investigative Journalists. This has triggered numerous reactions worldwide, but it is unclear, at this stage, if and to what extent the leaks will result in further investigation by the E.U. Commission into Luxembourg's tax ruling practice. The Director General of Competition has stated that the European Commission considers the leaked documents to be market information and that it will examine the documents and evaluate whether or not they will lead to the opening of new cases.[3] As of June 8, 2015, no new cases have been opened.

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[3] See http://www.euractiv.com/sections/eu-priorities-2020/vestager-says-will-use-luxleaks-documents-eu-tax-probe-310189.

Developments in Exchange of Information

Luxembourg and the United States concluded an intergovernmental agreement ("I.G.A.") on the application of F.A.T.C.A. in Luxembourg on March 28, 2014, in accordance with the so-called "Model 1." On March 27, 2015, a draft bill implementing the I.G.A. in Luxembourg domestic law was submitted to the Luxembourg parliament. It is expected that the I.G.A. will be implemented in Luxembourg law in the second or third quarter of 2015.

On May 26, 2014, Luxembourg's parliament ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the "Convention"). The Convention, currently signed by over 60 countries, provides the new O.E.C.D. standard for international assistance between tax authorities.

On November 25, 2014, the withholding tax system under the E.C. Savings Directive was abolished in favor of automatic exchange of information on savings income, effective January 1, 2015, by way of law (see in this respect **Interest Payment on (Hybrid) Debt**, above). In addition, the new law approves similar agreements concluded between Luxembourg and other territories associated with the E.U. In the treaty context, another law of the same date has introduced a new procedure for the exchange of information upon request, limiting the possibility for Luxembourg tax authorities to dismiss a foreign request for exchange of information and abolishing the judicial review in Luxembourg on the initiative of the taxpayer or information holder.

"Luxembourg and the United States concluded an intergovernmental agreement ('I.G.A.') on the application of F.A.T.C.A. in Luxembourg on March 28, 2014, in accordance with the so-called 'Model 1.'"

Luxembourg also confirmed that it will comply with the Common Reporting Standard, as developed by the O.E.C.D., and will become part of a multilateral agreement in 2016. As such, Luxembourg is part of the group of "early adopters" and will, in principle, begin automatically exchanging information on financial institutions on a global basis as of 2017 (regarding information related to the tax year 2016).

Finally, on March 18, 2015, the European Commission published a proposal to amend the Directive on administrative cooperation between E.U. Member States (Directive 2011/16/EU) that will introduce mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements (the "Proposal"). The Proposal, which is currently being discussed by the European parliament, is aimed at enhancing fiscal transparency between E.U. Member States and deterring aggressive tax planning and abusive tax practices.

The proposed automatic exchange will cover rulings and pricing arrangements (i) issued after the amendment becomes effective and (ii) issued less than ten years prior that remain in force. Only rulings involving cross-border transactions are covered by the Proposal, and rulings concerning only natural persons are excluded.

The automatic exchange should include a defined set of basic information that will be sent to all Member States and the E.U. Commission. After the exchange of information takes place, an E.U. Member State may request additional information if it believes such information is relevant to the application of its own tax rules. If approved, the proposed amendment will be effective as of January 1, 2016. Rulings and pricing arrangements issued after this date will need to be communicated within one month following the end of the quarter in which they are issued. Rulings and advance pricing arrangements issued within the 10-year lookback period will be communicated before December 31, 2016, if they remain in force as of the effective date.

UNITED KINGDOM

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INTRODUCTION

This summary of United Kingdom ("U.K.") law is correct as of May 29, 2015.

The tax authority in the U.K. is called H.M. Revenue & Customs ("H.M.R.C.").

The U.K. has long formed the *de facto* European or international headquarters for many U.S.-based multinational companies.

Individuals

The U.K. system of taxing individuals who are resident but not domiciled in the U.K. – the so-called "remittance system," under which an individual's foreign-source income and capital gains are broadly only taxed in the U.K. to the extent those amounts are remitted to the U.K. – has made the U.K. an attractive and cost-effective center for locating foreign executives.

- Non-domiciled individuals who have been resident in the U.K. for substantial periods of time must pay a charge to use the remittance basis:
- Non-domiciled individuals who have been resident in the U.K. for 17 of the last 20 tax years must pay a £90,000 annual charge;
- Non-domiciled individuals who have been resident in the U.K. for 12 of the last 14 tax years must pay a £60,000 annual charge; and
- Non-domiciled individuals who have not met the 12-year test but who have been resident in the U.K. for 7 of the last 9 years must pay a £30,000 annual charge.

The charge for 12-year residents was introduced by Finance Act 2012 and entered into effect on April 6, 2012, and the charge for 17-year residents was introduced by Finance Act 2015 and entered into effect on April 6, 2015. Finance Act 2014 also introduced new rules to limit the effectiveness of certain "dual contract" arrangements sometimes used by non-domiciled individuals to reduce their exposure to U.K. income tax.

The U.K. government is currently consulting on revising the remittance basis rules so that when a non-domiciled individual opts to use the remittance basis and pay the relevant charge, they must do so for a minimum period of time. Such minimum period may be three years or possibly longer, particularly for longer term residents, and thereafter, the period might be renewed or rolled over on an annual basis. The consultation closed in April 2015, and it is the government's intention to introduce legislation to take effect starting April 2016.

Finance Act 2012 also included measures intended to encourage non-domiciled individuals to invest in the U.K. Where these apply, individuals will not be treated as having remitted the income to the U.K. provided that an appropriate claim is made. The "relief" is not available if the remittance is part of a scheme or arrangement to avoid tax. Care must be taken, as it is possible that funds brought into the U.K. under these rules may still be treated as remitted to the U.K. and therefore fall within the U.K. tax net.

The U.K. introduced, with effect from April 6, 2013, a statutory tax residence test that, at least in theory, is intended to provide certainty to foreign executives about their U.K. tax position. Individuals should note that U.K. tax residency status under the statutory residence test may differ from treatment in prior years. Measures were also introduced in Finance Act 2014 to combat the misuse of artificial dual contracts by non-domiciled employees.

Corporations

The U.K. corporate tax regime continues to offer a number of attractive features:

- Competitive corporation tax rates – On April 1, 2015, the main rate of U.K. corporation tax went down from 21% to 20%. As a result, from April 1, 2015, the main rate of corporation tax, the basic rate of income tax, and the standard V.A.T. rate are all 20%;
- Exemption from corporation tax for most dividends received from U.K. – and foreign-resident companies, backed up by a foreign tax credit system where the exemption does not apply;
- No withholding tax on dividends paid by U.K. companies to nonresident shareholders (except for distributions made by certain types of investment funds, such as Real Estate Investment Trusts, herein "R.E.I.T.'s");
- Exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups;
- No capital gains tax, in general, on the sale of shares in U.K. companies by nonresidents – it is now also possible, in some circumstances, to structure asset sales in a tax-effective way in order to obtain the protection of the substantial shareholding exemption;
- No capital taxes on formation or paid-in capital of companies;
- An optional "patent box" regime, introduced as part of the U.K. strategy to incenti*vize* innovation, and the development and retention of certain intellectual property ("I.P.") rights in the U.K. – Broadly, under the patent box regime, the worldwide profits from the exploitation of eligible patents or other qualifying rights held by qualifying companies will ultimately be subject to a lower U.K. corporation tax rate of 10%. The rules to implement the patent box regime came into force on April 1, 2013, although the full benefit (*i.e.*, taxation of relevant, qualifying profits at 10%) will not be available until 2017. Taxpayers must elect into the new regime. Patent box regimes throughout Europe have been the subject of an antitrust investigation aimed specifically at nine jurisdictions with patent box legislation. In November 2014, the U.K. and Germany issued a joint proposal on I.P. tax regimes for consideration by

the O.E.C.D. Forum on Harmful Tax Practices ("F.H.T.P."). In the proposal, modifications to the availability of preferential I.P. tax regimes are set out pursuant to which the taxpayer seeking to benefit from the preferential I.P. tax regime would be required to have substantial economic activities in the jurisdiction in which that preferential regime exists (the "modified nexus approach" or "M.N.A."). Additionally, such tax benefits should be directly connected to research and development expenditures. The proposal also suggested that the existing regimes be closed to new entrants in June 2016 and fully abolished in June 2021. Taxpayers currently within these regimes would be allowed to retain the benefits until June 2021. The F.H.T.P. welcomed this approach, and in December 2014, the U.K. government announced that it intends to implement the joint proposal and will consult on changes to the U.K. legislation once the F.H.T.P. has reported on how the proposal will work in practice;

- A new "above the line" research and development ("R&D") tax credit for qualifying companies that incur qualifying expenditures on or after April 1, 2013 – Until March 31, 2016, companies will be able to choose between the so-called "super deduction" regime (under which "large" companies can claim a tax deduction of 130% of qualifying expenditures and "small and medium enterprises" can claim a deduction of 230% of qualifying expenditures) and the new "above the line" credit system. After that date, the "above the line" credit regime will be compulsory. Under the new regime, eligible companies (including those with no corporation tax liability, such as those with losses) will be paid a taxable credit to the value of 11% of their qualifying R&D expenditures;

- The most extensive tax treaty network in the world, covering around 120 countries; and

- Official confirmation that the U.K. will not introduce a financial transactions tax ("F.T.T.") unless introduced on a global basis – In April 2014, the U.K.'s preliminary legal challenge against a decision authorizing the use of enhanced co-operation to implement an F.T.T. was rejected by the European Court of Justice ("E.C.J.") as being premature (no proposals with respect to the F.T.T. itself had yet been adopted). A further challenge, if and when E.U. F.T.T. legislation is adopted, remains likely.

Some of the key components of the U.K. tax system (such as the controlled foreign company ("C.F.C.") regime and taxation of foreign branches of U.K. companies, interest, and dividend income) have undergone material changes in recent years as part of the drive to make the U.K. tax system more competitive and "business friendly." As well as these statutory changes, there have also been a number of noteworthy decisions handed down by the E.C.J. and the U.K. courts. Key E.C.J. decisions include:

- The Franked Investment Income/Foreign Dividend Group Litigation (Case C-446/04) (see below);

- The *Cadbury Schweppes plc v H.M.R.C.* (Case C-196/04) (see below); and

- The Thin Cap Group Litigation (Case C-524/04).

As a direct result of these cases, an exemption system for foreign dividends was introduced in Finance Act 2009, which is now contained in Part 9A of the Corporation Tax Act 2009 ("C.T.A. 2009"), and a new C.F.C. regime was legislated under Finance Act 2012, which formed Part 9A of the Taxation (International and Other Provisions) Act 2010 ("T.I.O.P.A. 2010"). Finance Act 2009 also imposed limitations on the deductibility of intra-group interest expense of corporate groups (referred to as the worldwide debt cap). These rules are contained in Part 7 of T.I.O.P.A. 2010.

"On April 1, 2015, the main rate of U.K. corporation tax was reduced from 21% to 20%."

Other notable E.C.J. decisions affecting the U.K.'s status as a holding company jurisdiction include the Marks & Spencer plc v. Halsley decision (Case C-446/03) as a result of which, U.K. holding companies are able to claim the losses incurred by subsidiaries tax resident in other E.U. Member States under certain circumstances.

Also of note is the decision of the E.C.J. in *Revenue and Customs Comrs v. Philips Electronics U.K. Ltd* (Case C-18/11). The case concerns a claim for consortium relief. H.M.R.C. rejected the claim on the ground that the requirements of the U.K. consortium relief rules were not met. At the time, U.K. legislation required the companies connecting the group claiming the losses to the joint venture to be within the charge to U.K. corporation tax. The E.C.J. concluded that the U.K. rules in question, which prevented losses of a U.K. permanent establishment of a nonresident company from being surrendered for group relief, constituted an unjustified restriction of freedom of establishment under E.U. law, and should be struck down.

On a similar point, in *F.C.E. Bank* (see **Controlled Foreign Companies**, below) it was held that the old U.K. group relief rules, which prevented a claim for group relief between two U.K. subsidiaries both owned by a U.S. parent, contravened the non-discrimination article in the 1975 U.S.-U.K. Double Tax Treaty.

Finance Act 2011 amended the U.K. rules so as to:

- Remove the requirement that the linking company be subject to the U.K. corporation tax regime and expand relief to any qualifying E.E.A. company; and
- Cap the ability to claim relief by virtue of a test based on the level of control and proportion of voting rights held in the loss vehicle.

CORPORATE TAX RATE

On April 1, 2015, the main rate of U.K. corporation tax was reduced from 21% to 20%.

U.K. corporation tax is levied on the worldwide income and gains of U.K.-resident companies. Capital gains derived by U.K. companies are generally included in the companies' profits for the purposes of corporation tax and taxed at the same rate as income. Certain "non-natural persons" holding high value (over £1 million) U.K. residential real estate assets are subject to an annual charge on that real estate (the "annual tax on enveloped dwellings" or "A.T.E.D."), subject to certain exemptions. When an asset falls within the scope of the A.T.E.D. charge, the disposal of that asset is subject to a capital gains tax charge of 28% ("A.T.E.D.-related capital gains tax"). With effect from April 6, 2016, the threshold for A.T.E.D. will drop to £500,000. However, the base cost of assets is indexed by reference to the U.K. retail price index to eliminate gains based on inflation (although this indexed relief does not apply to the high value residential property charge).

In Finance Act 2015, the government also extended the capital gains tax charge on disposals of residential property to cover all disposals by nonresidents as of April 6, 2015, ("nonresident capital gains tax"). "Nonresidents" include individuals, companies, trustees, and personal representatives. The rate of the charge is 18% or 28% for individuals (depending on that individual's overall taxable income and the rate at which they pay income tax), 20% for companies, and 28% for trustees and personal representatives. Where a disposal by a company falls within the charge to nonresident capital gains tax, that chargeable gain is not subject to corporation tax (although the rates are currently the same). It is possible that a disposal may fall within the scope of both the A.T.E.D.-related capital gains tax and the nonresident capital gains tax. In such circumstances, A.T.E.D.-related capital gains tax is applied first, and nonresident capital gains tax will apply only to gains that are not subject to A.T.E.D.-related capital gains tax.

A small profits rate of 20% does exist for companies whose profits did not exceed £300,000. For 2014-2015, if a company's profits exceeded £300,000 but were below £1.5 million, a rate between 20% and 21% is applied; a 21% rate is applied to companies whose profits exceeded £1.5 million. As of April 1, 2015, both the main rate and the small profits rate are 20%; so, for the time being, the graduated rate variation dependent on profits is of no economic effect.

Computation of profits for corporation tax purposes generally follows U.K. G.A.A.P. or International Accounting Standards in the case of companies whose shares are listed on an exchange in the E.U. As a result of successive reforms, specific codes apply accounting principles to profits on loan relationships (*i.e.*, interest), foreign exchange gains and losses, derivative contracts, and I.P. rights and other intangibles.

DIVIDENDS RECEIVED BY U.K. COMPANIES

From July 1, 2009, a unified system for taxing dividends received by U.K.-resident companies applies to dividends both from U.K.-resident and nonresident companies. In principle, any dividend or other distribution is liable for corporation tax unless it is exempt. Distributions received by companies other than small companies are exempt if (a) they fall into an exempt class, (b) they do not represent payments of interest deemed to be distributions, and (c) no deduction is allowed for a resident of any territory outside the U.K. under local law in respect of any amount determined by reference to the distribution.

In practice, most distributions fall into one of following the exempt classes:

- Distributions from controlled companies;
- Distributions with respect to non-redeemable ordinary shares;
- Distributions with respect to portfolio holdings, which are holdings of less than 10%;
- Dividends derived from transactions not designed to reduce tax;
- Dividends with respect to shares accounted for as liabilities of the issuer under G.A.A.P. applicable to the balance sheet of the holder, but that have different characterization for U.K. tax purposes – the shares are treated only as equity of the issuer for U.K. tax balance sheet purposes because they are

held for non-business reasons or possibly for tax avoidance purposes of the holder;

- Capital distributions made out of reserves arising from a reduction in capital.[1]

Each has anti-avoidance measures designed to prevent manipulation of the exemptions. In addition, other anti-avoidance rules (including the general anti-abuse rule, or "G.A.A.R." – as to which, see **The General Anti-Abuse Rule and Further H.M.R.C. Powers**) may preclude a taxpayer from claiming the exemptions in certain cases, such as schemes in the nature of loan relationships where the return is the economic equivalent of interest, schemes involving payments for distributions or payments not on arm's length terms, as well as schemes involving diversion of trade income.

FOREIGN TAX CREDIT

Where the exemptions described above do not apply, or where the U.K. corporate shareholder elects out of the exemption, the general rule is that a credit is granted against U.K. corporation tax for foreign withholding tax levied on dividends. In addition, an indirect foreign tax credit (referred to in the U.K. as "underlying credit tax") is granted in respect to tax paid on profits by nonresident companies (out of which the dividend was paid) where the U.K. company has a substantial interest in the foreign company. The threshold is, in most cases, determined by a treaty. The usual requirement is that the recipient company directly or indirectly controls, or is a subsidiary of a company which controls, shares that represent at least 10% of the voting power in the paying company. Provided that the dividend payer and the recipient are associated, underlying tax in this context includes underlying tax from related companies through an indefinite number of successive levels in the corporate chain. For this purpose, two corporations are associated if the shareholder receiving the dividend directly or indirectly controls 10% or more of the voting power in the paying company. Alternatively, the shareholder may be a subsidiary of a company that controls the dividend-paying company under the foregoing standard.

"Where the exemptions described above do not apply... a credit is granted... for foreign withholding tax."

Finance Act 2014 introduced changes to the double taxation rules in Part 2 of T.I.O.P.A. 2010 to reduce the credit given against company income if a foreign tax authority has repaid any amount of foreign tax paid, to not just the claimant company, but also to any connected person or a third party as a result of a scheme (which is broadly defined). This measure has effect on payments made by foreign tax authorities on or after December 5, 2013.

Source of Income

Although the U.K. does not have a "basket" system for allocating foreign tax credits, the "source" doctrine has imposed significant restrictions on the pooling of foreign tax credits. The shares in a foreign company constitute a distinct source, and the foreign tax may only be credited against income from that particular source. In certain cases, a particular class of shares in a company may be a distinct source.

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[1] Distributions that are capital in nature and which fall outside of the "dividend exemption" may be subject to corporation tax on taxable gains, unless the substantial shareholding exemption or another exemption or relief is available.

Credit Pooling

Previously the U.K. had a relatively complex regime of "onshore pooling" of foreign tax credits, allowing excess foreign tax credits from one source to be applied against the U.K. tax due on other foreign-source dividends. However, this regime has been discontinued now that the U.K. has a unified system of taxing (and usually exempting) dividends from resident and nonresident companies. In the majority of cases there will now be no U.K. tax liability levied on the corporate recipient of an overseas dividend and no need for a credit pooling system to relieve any associated U.K. tax liability.

Anti-Avoidance

Broad spectrum anti-avoidance rules aimed specifically at foreign tax credits are found in §§81-82 T.I.O.P.A. 2010. The legislation is designed to address arrangements where income is acquired for the purpose of securing excessive credit for foreign tax, such as "dividend buying." This is where extra income is deliberately bought and the credit claimed to be due is more than the U.K. tax due on that income.

The legislation applies where four conditions are satisfied:

- Foreign tax is allowable as a credit against U.K. tax under any arrangements;
- There is a scheme or arrangement, the main purpose, or one of the main purposes of which, is to cause an amount of foreign tax to be taken into account;
- The scheme or arrangement is prescribed; and
- The aggregate of claims for credit that have been made or that may be made by the taxpayer and any connected persons is more than minimal.

Schemes or arrangements are prescribed by §§83-88 T.I.O.P.A. 2010. They are briefly where, in addition to being "tax avoiding" by nature:

- The foreign tax is not properly attributable to the source from which the income is derived;
- The payer of the foreign tax and any person(s) associated with the transactions have not jointly suffered the full cost of the foreign tax;
- A claim or election that could have been made and which would have reduced the foreign tax credit eligible for relief was not made, or a claim or election was made that increased the amount of the relief;
- The foreign tax credit reduces the tax payable to less than would have been due if the transaction had not occurred; or
- The income subject to foreign tax was acquired as a consideration for a tax deductible payment.

Where these criteria are met, H.M.R.C. will issue a notice directing the application of the legislation.[2] Taxpayers are then required to form a view on how the legislation should apply and self-assess or amend any existing self-assessment in the normal

[2] §§81(1), (2), and 82(2) T.I.O.P.A. 2010.

way.[3] Disputes regarding the application of the rules will be resolved through the self-assessment enquiry and appeals procedure. Where the legislation is invoked, the credit claim will be limited so as to cancel the effect of the scheme or arrangement.[4]

The rules are elaborated where underlying tax of nonresident companies is involved. In such a case, the counteraction will apply where, had the nonresident company that paid the foreign tax been U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company.[5]

"The U.K. does not impose withholding tax on dividends."

It is worth noting that the U.K. G.A.A.R. will apply in addition to the anti-avoidance rules set out here (see **The General Anti-Abuse Rule and Further H.M.R.C.**, below).

Hybrid Instruments

Where certain payments may be characterized as both dividends for U.K. tax purposes and interest payments in another jurisdiction, the foreign payer may obtain a tax deduction for foreign tax purposes, while a U.K. corporate recipient otherwise meeting the requirements of §§12-16 T.I.O.P.A. 2010, or treaties providing similar treatment (such as the U.S.-U.K. Income Tax Treaty), obtains a credit for underlying tax in respect of the receipt. Credit for underlying tax will not be given if a tax deduction is given in another jurisdiction, calculated by reference to the amount treated as a dividend for U.K. purposes.[6] The denial of credit for foreign tax is automatic and not limited to instruments created or assigned for the purpose of obtaining the benefit of the credit.

DIVIDENDS PAID BY U.K. COMPANIES TO U.S. SHAREHOLDERS

The U.K. does not impose withholding tax on dividends. Withholding tax at the rate of 20% applies to property income distributions ("P.I.D.'s") paid in relation to certain qualifying activities by U.K.-resident R.E.I.T.'s. This may be reduced by an applicable tax treaty. Since a company cannot qualify as a R.E.I.T. if it has shareholders with a 10% or greater participation, only the rate on portfolio holdings will apply. The rate is 15% under the current U.K.-U.S. Double Tax Treaty for qualified U.S. residents. The position is essentially the same with respect to the 20% withholding applied to property income distributions made by property-authorized investment funds.

DIVERTED PROFITS TAX

The Diverted Profits Tax ("D.P.T.") is a new U.K. tax introduced in Finance Act 2015 and applicable from April 1, 2015. Broadly, it aims to prevent multinational groups of companies from structuring their affairs so that profits which are generated in the U.K. are not subject to U.K. taxation.

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[3] §§91-95 T.I.O.P.A. 2010.

[4] §90 T.I.O.P.A. 2010.

[5] §81 T.I.O.P.A. 2010.

[6] §57(3) T.I.O.P.A. 2010.

The D.P.T. is targeted to counteract arrangements which aim to eliminate or reduce U.K. tax liabilities by avoiding having a U.K. permanent establishment or diverting profits to related parties where the primary aim of such an arrangement is to exploit tax differentials to avoid or reduce U.K. tax liability and the arrangement otherwise lacks economic substance. The rules are complex, widely drawn, and are supplemented by detailed H.M.R.C. guidance and examples. What follows is therefore a very high level summary.

A D.P.T. charge will broadly arise to "Party A" in either of the situations described below.

- In relation to a non-U.K. resident trading company (Party A); another person (the "avoided P.E.") carries on an activity in the U.K. in connection with the supply of services, goods or other property made by Party A in the course of Party A's trade, and it is reasonable to assume that such activity is carried on in a way which is designed to ensure that Party A does not carry on a trade in the U.K. through a permanent establishment. A key purpose of the arrangements must be to avoid or reduce U.K. corporation tax and/or to benefit from a "tax mismatch" (with the "insufficient economic substance" condition also being met).
- A U.K. company, or a permanent establishment of a non-U.K. resident company (Party A), enters into a provision with another person (Party B), a "participation" condition is met between Party A and B, there is an "effective tax mismatch outcome" and the "insufficient economic substance" condition is met.

"D.P.T. is targeted to counteract arrangements which aim to eliminate or reduce U.K. tax liabilities by avoiding having a U.K. permanent establishment or diverting profits to related parties."

Broadly a "tax mismatch" occurs, subject to certain exceptions, when the reduction in a company's tax liability is substantial when compared to the increased tax charge (on any diverted profits), with an 80% threshold set. In other words, the D.P.T. will generally not apply where the diverted profits are subject to tax at a rate at least equal to 80% of the rate of U.K. corporation tax. The "insufficient economic substance" test is met where, broadly, it is reasonable to assume that the transactions were designed to secure the tax reduction unless it would also be reasonable to assume that the non-tax benefits of the transactions outweigh the tax benefits.

D.P.T. will be charged at a rate of 25% of the amount that would have been subject to U.K. corporation tax if a permanent establishment had been in place or if the arrangement leading to the tax mismatch had been structured so that the tax mismatch did not arise. A higher rate of 55% is chargeable on certain profits of oil and gas companies. A D.P.T. charge will not, however, arise unless the non-U.K. resident company's U.K. sales revenue (including the U.K. sales revenue of any connected company's which have not been subject to U.K. corporation tax) exceeds £10 million. A D.P.T charge will also not arise if the total expenses of the non-U.K. resident company (and any connected companies) that relate to activity in the U.K. do not exceed £1 million, and there are exemptions for certain loan relationships.

The D.P.T. is not self-assessed. Companies must notify H.M.R.C. when certain of the D.P.T. conditions are met such that the company considers it will potentially be subject to a charge. H.M.R.C. will then issue a notice of charge which must be paid within 30 days. A review and appeals process is also provided for in the D.P.T. legislation.

CAPITAL GAINS TAX EXEMPTION ON THE DISPOSAL OF OPERATING COMPANY SHARES

As of April 1, 2002, the disposal by U.K. companies of shares in operating companies may qualify for exemption from U.K. tax on the gain, if certain substantial shareholding requirements are met. This is referred to as the substantial shareholding exemption ("S.S.E.").

SUBSTANTIAL SHAREHOLDING

The main requirements are that the investing company must have had a substantial shareholding in the company invested in throughout a 12-month period beginning no more than two years before the day on which the disposal takes place. A substantial shareholding is at least 10% of the company's ordinary share capital. The shareholder must also be beneficially entitled to not less than 10% of the profits available for distribution and 10% of the assets on a winding-up.

From 2011, the benefit of the S.S.E. has been broadly extended to certain de-grouping charges incurred by the transferor.

By way of background, the U.K. imposes a tax charge if a company leaves a group within six years of the occurrence of certain events, such as an asset transfer. The de-grouping gain (or loss) would have ordinarily been triggered in the departing company. However, from April 1, 2011, these de-grouping gains/losses will fall to be taxed in the hands of the transferor company and the gains (or losses) will be added to or subtracted from the consideration received by the transferor for its disposal of its shares in the transferee. In consequence, no de-grouping charge should arise in the company leaving the group if the disposal qualifies for the S.S.E., although a tax charge will still arise in that company if the de-grouping is otherwise than on a share disposal (*e.g.*, the issue of new shares).

Coupled with other changes, it is now possible to structure a trading business sale in the U.K. without giving rise to a chargeable gain by hiving down the business to a newly set up subsidiary and selling that subsidiary under the protection of the S.S.E. In addition, in Finance Bill 2014, the government has introduced provisions to extend S.S.E provisions to companies holding subsidiaries engaged in oil and gas exploration under specified circumstances.

TRADING COMPANY LIMITATIONS

The investing company must have been a trading company or a member of a qualifying group from the start of the 12-month period ending at the time of the disposal. It must also be a trading company or generally, a member of a trading group immediately after the disposal. In addition, the company invested in must have been a trading company over the same time period, the holding company of a trading group, or a trading sub-group.

A trading group means a group in which one or more members carry on trading activity. In addition, the activity of the group members, when taken together, must not include "to a substantial extent" activities other than trading activities. "Trading company" and "trading sub-group" are defined in a similar manner. H.M.R.C. has

indicated that it will interpret this as meaning that 80% of the value of the group must be attributable to trading activity.

For this purpose, a 51% holding in a company is sufficient to make that company a group member. Under this definition, the activities of companies in which minority participations are held are ignored in determining whether a group qualifies for the exemption. However, in the normal course, smaller participations in joint ventures will fall outside the group and, on ordinary principles, could be treated as investments by the group member holding the participation.

To avoid relatively harsh results when a group member invests in a joint venture, joint ventures are given special recognition. Under a special rule, a participation in a joint venture company will not dilute the trading activity of the company, as long as the holding is at least 10%. A joint venture company in this context is one where at least 75% of the shares are held by five or fewer persons. Intra-group activities are ignored for this purpose. In addition, funds held for the purpose of reinvestment in a trading company of a qualifying joint venture shareholding are regarded as part of the trading activity provided the investment is made within a reasonable time. An anti-avoidance provision seeks to deny the exemption where arrangements are made with the sole or main purpose of securing the exemption and the profits of the company being sold are untaxed. This is likely to be of narrow application.

Any gain or loss that would have arisen under the foreign exchange matching rules, connected with a disposal of a substantial shareholding will no longer be a chargeable gain or capital loss. This is a logical extension of the exemption in relation to foreign shareholdings where the currency exposure has been hedged.

Disposals of shareholdings that do not meet this requirement will be liable to corporation tax on any gains realized on the disposal. Capital losses are allowable, but may only be offset against capital gains of the accounting period of the company in which the disposal arises, or otherwise carried forward.

CAPITAL GAINS ON THE DISPOSAL BY NONRESIDENTS OF SHARES IN U.K. COMPANIES

The U.K. does not normally tax the disposal of shares in U.K. companies by nonresident shareholders. A limited exception exists in the case of shares of oil companies whose value is based on exploration or exploitation rights in the U.K. sector of the North Sea. In addition, anti-avoidance provisions relating to U.K. real property may, in certain circumstances, trigger a liability to income tax on the sale of shares of companies whose value is based on U.K. real estate. Shares forming part of the assets of a U.K. branch of a nonresident company may also be liable to capital gains tax.

CAPITAL TAX AND STAMP DUTY

There is no capital tax on the formation of a company or on any capital paid in. No stamp duty is paid on share subscriptions. Transfers of shares of U.K. companies are generally liable to stamp duty or stamp duty reserve tax (“S.D.R.T”) at 0.5% of the consideration for the sale, albeit various exemptions can apply (for example, for certain intragroup transfers, and for transfers of shares on “recognized growth markets” such as the Alternative Investment Market). This may be increased to

1.5% where shares of incorporated companies are issued or transferred into a clearing system or a depository receipt facility. In 2012, the First Tier Tribunal in *HSBC Holdings and Bank of New York Mellon Corporation v. The Commissioners for H.M.R.C.* [2012] U.K.F.T.T. 163 (T.C.) held that the U.K. S.D.R.T. charge of 1.5% levied on the issue of depositary receipts (including American Depositary receipts, "A.D.R.'s") infringed E.U. law if the imposition is in connection with the raising of capital by an E.U. company, even if the depositary happens to outside the E.U. In consequence, the 1.5% S.D.R.T. charge will no longer be levied on issues of U.K. shares or securities to depositary receipt issuers and clearance services anywhere in the world. Going forward, the 1.5% S.D.R.T. charge will only apply to transfers (on sale or otherwise on sale) of shares and securities to depositary receipt systems or clearance services that are not an integral part of the issue of share capital. H.M.R.C. has confirmed that it will not appeal the *HSBC* decision.

As noted above, the U.K. does not propose to introduce the European F.T.T. into domestic law. On April 30, 2014, E.C.J. rejected the U.K.'s challenge to the E.U. Council decision authorizing the enhanced co-operation of certain E.U. Member States in the area of F.T.T. on the grounds that it was premature. A further challenge (in due course) looks likely.

TAX TREATY NETWORK

The U.K. has treaties in effect with approximately 120 jurisdictions.

The U.K. treaty negotiating position is to prevent against the risk of double taxation where the same income is taxable in two states, to provide certainty of treatment for cross-border trade and investment, and to prevent excessive foreign taxation and other forms of discrimination against U.K. business interests abroad. The treaties are also designed to protect the government's taxing rights and to protect against attempts to evade or avoid tax. There has been a particular drive towards reducing tax evasion and avoidance in recent years and, as a part of this, tax treaties now provide for the exchange of information between H.M.R.C. and other national tax authorities.

The significance of the extensive U.K. treaty network is also in reducing or eliminating non-U.K. taxes on payments made to recipients that are resident in the U.K. More specific aims of U.K. tax treaties include seeking to eliminate withholding taxes on interest and royalties. About one quarter of the U.K. treaties achieve this, with others typically reducing the rates. Additionally, almost all treaties reduce foreign withholding taxes on dividends. In the case of dividends paid by subsidiaries in other E.U. member states, the E.U. Parent-Subsidiary Directive eliminates withholding tax. A 10% minimum shareholding in the subsidiary is required to qualify under the Directive. U.K. treaties commonly exempt the disposal of shares from capital gains tax in the source state. Intragroup interest and royalty payments may also be free of withholding tax when paid to an associated company in another E.U. member state pursuant to the European Interest and Royalties Directive.

DEBT FINANCING OF U.K. COMPANIES

The U.K. has liberal rules in connection with the deduction of interest expense. Most interest expense and other costs of debt finance are deductible. Deductibility is determined, depending on the circumstances, on either the fair value or amortized

cost basis. Related party financing must be in accordance with the amortized cost basis.[7] These rules apply in relation to "loan relationships." Loan relationships are broadly defined and exist in respect of a money debt that arose from a transaction for the lending of money. This is the case where a company, within the scope of U.K. corporation tax, is either a debtor or a creditor. A money debt for this purpose is one that is satisfied by the payment of money or the transfer of rights under a debt that is itself a money debt. Where a company issues an instrument as security for a money debt, a loan relationship similarly exists.

"The U.K. has liberal rules in connection with the deduction of interest expense. Most interest expense and other costs of debt finance are deductible."

Anti-avoidance provisions[8] permit the disallowance of interest expense where the interest or loan relationship has tax avoidance as its purpose, or as one of its main purposes. Although the legislation is widely drawn, it is generally regarded as applying in limited circumstances. In particular, recent discussions relating to interest expense incurred in order to acquire shareholdings that qualify for exemption from corporation tax under the S.S.E. described above will likely be permitted. Likewise, borrowing which is connected with the purchase of shares in respect of which foreign tax credits eliminate the U.K. tax liability are normally regarded as not contravening these rules. Other anti-avoidance provisions also aimed at denying interest expense deductions have relatively limited application.

The U.K. thin capitalization rules are imposed through the transfer pricing legislation. Interest will not be categorized as a "distribution" or dividend, but a deduction may not be allowable. The U.K. has neither fixed ratios nor safe harbors in this respect. A facts and circumstances approach is adopted based on ordinary transfer pricing principles. However, as an administrative matter, H.M.R.C. does not normally question related party borrowings where there is a debt-to-equity ratio of one to one and interest is covered by earnings in a ratio of one to three. Higher gearing can be agreed upon with H.M.R.C. on a case-by-case basis.

The debt cap rules described below will need to be considered when debt funding a U.K. company, as its ability to claim a deduction for interest expenses may be restricted.

The broad scope of the transfer pricing legislation may bring in a variety of indirect financing structures.

Most U.K.-source interest is subject to withholding tax at the rate of 20%. Exclusions apply for "short" interest that is interest on debt with a term of less than one year. Finance Act 2015 also provided for an exemption from withholding for certain private placements where a number of conditions are met. Interest on "quoted Eurobonds" may also be paid without deducting tax at the source. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized Stock Exchange. The U.K. government introduced a number of important changes to the taxation of interest in 2012. Broadly, these were as follows:

- In determining whether interest "arises in the U.K." for withholding tax purposes, no account is to be taken of the location of any agreement or deed evidencing specialty debt (that is interest paid under a deed).

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[7] §349 C.T.A. 2009.

[8] See §441 C.T.A. 2009.

- The value of interest that is paid in the form of goods or services will broadly be taken to be the market value of the goods or services at the time of payment. Similar rules will apply to the value of interest paid in the form of a voucher (including stamps and similar documents or tokens that may be exchanged for money, goods, or services). A person paying interest in the form of a voucher, goods, services, or funding bonds must provide the payee with a certificate showing the gross amount of interest paid, the amount of any tax deducted, the actual amount paid, and the date of payment.
- The issuer of a funding bond will be required to issue a certificate indicating its value on issue.

These feature in Schedule 11 to the Finance Act 2013 and took effect for most payments of interest made on or after October 1, 2013.

Finance Act 2013 also extended the "disguised interest" regime to income tax. Under these provisions, amounts which are "economically equivalent to interest" will generally be taxed as such. The measure applies to arrangements entered into on or after April 6, 2013 which result in the payment of amounts "economically equivalent to interest." At a very high level, an amount is "economically equivalent to interest" if it is reasonable to assume that it is a return by reference to the time value of that amount of money and paid at a rate that is reasonably comparable to a commercial rate of interest.

The U.K. G.A.A.R. will apply (amongst other things) to counteract any interest deductions claimed on other debt financing arrangements that are in breach of the spirit of the law and underlying policy of the legislation (refer to **The General Anti-Abuse Rule and Further H.M.R.C. Powers**, below).

In December 2014, the government published draft legislation making substantial changes to the loan relationship legislation. One of the most significant of these changes is the introduction of a new regime-wide "targeted anti-avoidance rule." The rule is broadly drafted and provides for tax advantages arising from avoidance arrangements to be counteracted by "just and reasonable" adjustments to the treatment of credits and debits. The draft legislation was not included in the Finance Act 2015. However, the government stated during the budget that it was its intention to enact the relevant legislation in substantially the same form as drafted following the general election. A second 2015 Finance Bill is therefore expected to include such provisions. Notably however, the draft legislation did not include clarification of the application of the regime to partnerships with corporate members, which the government is continuing to consult on.

ANTI-ARBITRAGE LEGISLATION

The U.K. statute book contains legislation[9] aimed at countering tax avoidance using arbitrage schemes that involve among others, hybrid entities. Where it applies, a deduction for corporation tax purposes will be denied to U.K. companies if, and to the extent that, more than one deduction (or an amount otherwise allowed for tax purposes) is available for the same expense, whether in the U.K. or elsewhere, and the income accruing or arising under the scheme is only taxed once.

[9] See part 6 of T.I.O.P.A. 2010.

In this context, four conditions must be met before the legislation applies:

- The U.K. company must be a party to a scheme that involves, *inter alia*, a hybrid entity (a "qualifying scheme"). For these purposes, a hybrid entity is an entity that is recognized as a taxable person under one tax code (*e.g.*, the U.K.), but whose profits or losses are taxable under the same or another tax code in the hands of one or more persons other than the entity (*e.g.*, the U.S.). This may be because, for example, the two countries treat the same entity differently, one treating it as a company taxable on its own income (the U.K.), and the other seeing it as a partnership with its partners taxable themselves on their shares of its income (*e.g.*, the U.S.). "Scheme" is widely drafted to cover any arrangements or understandings whether or not legally enforceable;
- The qualifying scheme results in a U.K. tax advantage;
- The main purpose or one of the main purposes in adopting the qualifying scheme was the obtaining a U.K. "tax advantage." A U.K. tax advantage includes a relief or increased relief from tax or a deduction in computing profits or gains. This includes the deduction of the interest expense on the loans; and
- The amount of the U.K. tax advantage is not minimal (*i.e.*, if it exceeds £50,000[10]).

Where these conditions are met, the H.M.R.C. can issue a notice denying a corporation a tax deduction to the extent that in relation to the same expense, an amount may also be deducted or otherwise allowed in computing income, profits, or losses for the purposes of other non-U.K. tax. Thus, in principle, a U.K. company need not self-assess the application of this rule. However, the effect of such a notice is to require a taxpayer to either amend their self-assessment or appeal against the notice. No special rules are provided in relation to interest or penalties. Clearance provisions may be invoked to obtain H.M.R.C.'s confirmation of whether the legislation will apply to a planned series of transactions.

"The U.K. statute book contains legislation aimed at countering tax avoidance using arbitrage schemes that involve among others, hybrid entities."

WORLDWIDE DEBT CAP

A further restriction of the amount of interest claimed by the U.K. members of a multinational group by reference to the group's total consolidated external finance costs is contained in Part 7 of T.I.O.P.A. 2010 and takes effect for accounting periods starting after January 1, 2010. Broadly, the restriction applies to any worldwide group where the U.K. net debt of the group, exceeds 75% of the worldwide gross debt of the group. For this purpose, U.K. net debt of any company less than £3 million is treated as nil.

The total disallowed amount of the worldwide group is broadly the excess of the aggregate relevant financing expense amounts of U.K. resident group companies and permanent establishments of non-U.K. resident members, over equivalent amounts of the worldwide group. In calculating aggregate financing expense, the net financing expense of a company below £500,000 is treated as nil. The disallowed amount may be allocated among relevant companies as determined by the group,

[10] See INTM595080.

but failing proper allocation, is apportioned by formula. Where a financing expense disallowance arises, a corresponding exemption applies to financing income of relevant companies. Financing income received may also be exempt if the payer is a tax resident of an E.E.A. territory and is denied relief for payment. Exclusions apply to financial services groups, group treasury companies, charities and exempt bodies, stranded management expenses in non-trading loan relationships, R.E.I.T.'s, foreign branches, oil extraction companies, shipping operations within the tonnage tax, property rental businesses, and intra-group short term finance. Qualifying securitization companies are excluded.

Certain changes to the debt cap rules were introduced in Finance Act 2014. The amended legislation widens the ambit of the "grouping rules" used to determine the companies falling within the definition of "relevant group companies." Other provisions modifying the treatment of available profits and assets of companies for the purposes of the worldwide debt cap were also introduced.

CONTROLLED FOREIGN COMPANIES

Background

The U.K. controlled foreign companies regime, which is contained in Part 9A of T.I.O.P.A. 2010, seeks to apportion the profits of a controlled foreign company ("C.F.C.") to certain of its U.K. corporate shareholders. Previous versions of the U.K.'s C.F.C. rules were successfully challenged in the courts by taxpayers as contradicting E.U. law principles. The current system is, in part, the result of amendments made by the U.K. government to produce a C.F.C. system that is compliant with E.U. law.

Overview of Current Regime

In outline, the C.F.C. regime imposes a charge on U.K. corporate shareholders of foreign resident, U.K. controlled companies that are perceived to have or derive "U.K.-source income."

The rules widely define the meaning of U.K.-source income for the purposes of the new code. There are five categories of income which are regarded as effectively "U.K.-source," and they are mutually exclusive:

- Profits of the C.F.C. which derive from the exercise of significant people function in the U.K. or profits which are attributable to U.K. managed risks and assets;
- Profits from the provision of finance where the capital is provided from the U.K., where the C.F.C. has profits deriving directly or indirectly from U.K. connected contributions;
- Profits from the provision of finance in the course of a financial trade;
- Profits from captive insurance relating to U.K. risks; and
- Profits of a subsidiary which has opted into the solo consolidation regime under financial services regulatory rules.

A company can be controlled from the U.K. by reason of:

- Shareholder control – so-called "legal control;"
- Ownership or entitlement to assets – so-called "economic control;" and
- The U.K. company being a parent undertaking for accounting purposes even if consolidated accounts are not formally required – so called "accounting control."

There are six exemptions which operate either to reduce or fully to exempt the profits within the charge. These are assessed at the entity level. The main exemptions are:

- The "exempt period" exemption (effectively a grace period);
- The "excluded territories" exemption;
- The "low profits" exemption;
- The "low margin" exemption; and
- The "tax exemption" (*i.e.*, the exemption which looks at the rate of tax paid or payable by the C.F.C.).

Virtually every provision in the C.F.C. regime contains a form of anti-avoidance rule. As indicated above, these will apply in addition to the G.A.A.R.

The rules will also not subject a U.K. company to a U.K. C.F.C. charge unless the U.K. company holds a qualifying interest in the C.F.C. – broadly, a minimum of 25%.

There is an important exemption for finance companies that satisfy certain conditions. This exemption can be full or 75%. If the 75% exemption threshold applies, the finance C.F.C. will suffer an effective U.K. tax rate of 5% when the U.K. main 2015 corporation tax rate is 20%.

As a broad principle, the profits of the C.F.C. are calculated on the assumption that the U.K. accounting/tax rules apply.

The U.K. C.F.C. rules are notoriously complex (even in light of the recent reforms) and U.K. advice should always be taken.

C.F.C. Rules Apply to Profits, Not Gains

The C.F.C. regime seeks only to apportion profits liable to be taxed as income, rather than capital gains, to the U.K. corporate shareholders. Capital gains are therefore not within the C.F.C. rules. However, certain items that in general terms might be thought of as giving rise to capital gains may not so qualify. In particular, the introduction of a separate tax regime relating to the taxation of intangible property eliminates the distinction between capital gains and ordinary income, taxing all amounts as income. As a result, disposals by C.F.C.'s of a bundle of assets that include intangible assets will result in a potential apportionment of profit to U.K. corporate shareholders. The most common example is likely to be goodwill.

It should be noted that a separate regime under T.C.G.A. 1992 applies to the attribution of capital gains of foreign companies to U.K. residents if the foreign companies would fall within the definition of "close companies" had they been U.K.-resident and if a targeted anti-avoidance test (introduced by Finance Act 2013) is met.

Taxation of Foreign Branches of U.K. Companies

Reflecting the rationale behind the move to dividend exemption, Chapter 3A of Part 2 of C.T.A. 2009 contains a broad exemption from U.K. corporation tax for the overseas trading profits, gains, and investment income of a permanent establishment (referred to in the legislation as a branch) of most U.K. resident companies.

Broadly, the calculation of profits falling within the exemption is determined in accordance with the treaty between the U.K. and the jurisdiction where the permanent establishment is established. If no such treaty exists, the model O.E.C.D. treaty is used. Special and complex rules apply to determine which losses and other reliefs such as capital allowances can be claimed.

The regime applies to all countries and territories – even those that do not have a double tax treaty with the U.K. – but an (irrevocable) opting-in election (made on an individual company basis) is needed.

Non-U.K.-resident companies may also opt into the regime for an accounting period in which they will become U.K.-resident, and the option will take effect from the date that the company becomes U.K.-resident.

Like the C.F.C. rules, the regime contains a number of anti-avoidance rules and the G.A.A.R. (see **The General Anti-Abuse Rule and Further H.M.R.C.**, below) will also apply, so specific advice should always be sought.

THE U.K.-U.S. DOUBLE TAX TREATY

The U.S.-U.K. Double Tax Treaty has recently been considered by the U.K. courts:

- In the case of *Swift v. H.M.R.C.* [2010] U.K.F.T.T. 88, the First Tier (Tax) Tribunal held that a U.K.-resident taxpayer who held an interest in a U.S. Delaware L.L.C. was entitled to claim relief for U.S. tax on income suffered on his share of the L.L.C.'s profits – as though the Delaware L.L.C. was transparent for tax purposes. The Upper Tribunal – although cited as *Revenue and Customs Commissioners v. Anson* [2011] U.K.U.T. 318 (T.C.), with which the Court of Appeal (*H.M.R.C. v Anson* [2013] E.W.CA. Civ 63) agreed – held that for U.K. tax purposes, the Delaware L.L.C. was opaque. In consequence, the taxpayers did not have an interest in the profits of the L.L.C. in any meaningful sense, and therefore, the profits on which the tax had been paid in the U.S. were the profits of the L.L.C. The double taxation treaty test was therefore not fulfilled and the taxpayer was prevented from claiming treaty benefits. The case was appealed to the Supreme Court and the hearings concluded on April 30, 2015. Judgment is yet to be handed down.[11]

- In the case of *Bayfine U.K. v. H.M.R.C.* [2011] E.W.C.A. Civ 304, the Court of Appeal held that a U.K.-resident taxpayer was not able to claim treaty relief for U.S. tax paid by the U.S. parent on the profits of the U.K. subsidiary. Specifically, the court held that the U.K. was not obliged to grant relief under the U.S.-U.K. Double Tax Treaty where doing so would be contrary to avoiding the imposition of double tax and minimizing tax avoidance.

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[11] After the printing of this article, the *Anson* case was reversed by the Supreme Court of the U.K. on July 1, 2015 (*Anson v Commissioners* [2015] U.K.S.C. 44).

- In the case of *H.M.R.C. v. F.C.E. Bank plc* [2012] E.W.C.A. Civ 1290, the U.K. Court of Appeal held that the old group relief rules which prevented two U.K. resident (sibling) subsidiaries of a U.S. resident parent company from forming a group for the purposes of surrendering trading losses contravened the non-discrimination article in the U.S.-U.K. Double Tax Treaty (albeit the 1975 U.S.-U.K. Double Tax Treaty). The U.K. taxpayer argued that relief was denied to it in circumstances where it would be available if the parent company were U.K. resident.

VALUE ADDED TAX ("V.A.T.")

The U.K. imposes V.A.T. on the supplies of most goods and services (with notable exclusions, including, for example, financial services). Currently, V.A.T. is charged at 20% ("standard rated"), although some supplies are subject to 0% ("zero rated") and others 5% ("reduced rated"). V.A.T. is intended to ultimately fall on the final consumer.

The V.A.T. treatment of supplies made by holding companies came under scrutiny by the E.C.J. in A.B. v. S.K.F. and also in a recent decision, *B.A.A. Limited v. The Commissioners for Her Majesty's Revenue & Customs* (the "B.A.A. case").

In the B.A.A. case, the Court of Appeal held that the V.A.T. incurred by the relevant group company on advisors' fees in connection with the takeover of the B.A.A. plc group in 2006 was irrecoverable.

As a general principle of V.A.T. law, a "taxable person" (a concept used by the V.A.T. legislation to describe a person who is engaged in economic activities) should be able to recover all the input V.A.T. incurred in the course of such economic activities. Conversely, V.A.T. is not recoverable by the "end user," or the person who acquires supplies on which V.A.T. has been charged, but who is unable to show that the supplies were used by it in connection with its economic activities.

It is established law that the mere holding of shares in a subsidiary does not amount to an economic activity for V.A.T. purposes. Hence, V.A.T. incurred by a parent company which is a mere holding company, in connection with the acquisition or disposal of the shares in subsidiaries, is generally not recoverable.

Holding companies seeking to recover V.A.T. should take steps to ensure that they carry on an "economic activity" for V.A.T. purposes (very broadly, a business) and certain other steps. Commonly, if this can be achieved, the V.A.T. costs on share acquisition/disposal and takeover may likely be recoverable.

The cases confirm that companies contemplating a share acquisition/disposal takeover should be able to recover V.A.T. incurred on fees if they can show an intention to make taxable supplies. The discussion contained in the *B.A.A.* decision suggests that, possibly, this may be achieved by the bidding company showing an intention to supply taxable services to target post-takeover (*e.g.*, management services), but following the decision, the intention to make taxable supplies may also be established where the acquirer is grouped (and there is clear evidence in the lead up to the transaction that there is an intention to group) for V.A.T. purposes with target as soon as the takeover completes. This is very fact-sensitive, and specific advice should be sought at the very early stages of a transaction.

In another area of development, in *Fiscale eenheid P.P.G. Holdings B.V. cs te Hoogezand v. Inspecteur van de Belastingdienst/Noord/kantoor Groningen*, Case C26-12, the E.C.J. ruled that V.A.T. on investment management fees paid for by an employer with respect to a pension scheme for its employees could be recovered by the employer. As a result of the case, H.M.R.C. amended its previous position (that V.A.T. on pension scheme investment management fees was essentially irrecoverable for employers, albeit with some partial recovery where investment and actuary services were provided together) so that it is now accepted that V.A.T. on pension scheme investment management fees paid for by an employer is now potentially fully recoverable by that employer. However, to recover the V.A.T. on such fees, it must be clear from the investment manager's contract that the services are supplied to the employer, rather than just to the pension scheme trustee. H.M.R.C has published a number of briefings on this issue, setting out their view of the minimum criteria that must be met for such V.A.T. to be recovered, with further guidance from H.M.R.C. expected in the summer of 2015.

"Arrangements will be considered to be 'abusive' if they are 'arrangements the entering into or carrying out of which cannot be reasonably regarded as a reasonable course of action...'"

THE GENERAL ANTI-ABUSE RULE AND FURTHER H.M.R.C. POWERS

Finance Act 2013 contains provisions that enact a G.A.A.R. in the U.K.

The U.K. G.A.A.R. is broadly intended to counteract "tax advantages" (which include obtaining a relief or an increased relief from tax) in respect to most taxes (but not, for example, V.A.T.) arising from "tax arrangements" (including agreements, understandings, and transactions, whether or not legally enforceable) that are "abusive." Therefore, the following conditions must be satisfied for G.A.A.R. to apply:

- The presence of an arrangement giving rise to a tax advantage;
- The tax advantage relates to a tax covered by G.A.A.R.;
- One of the main purposes of the arrangement is to obtain the tax advantage (having regard to all the circumstances); and
- The arrangement is "abusive."

Arrangements will be considered to be "abusive" if they are "arrangements the entering into or carrying out of which cannot be reasonably regarded as a reasonable course of action having regard to all the circumstances." This is referred to as the "double reasonableness test." The circumstances that can be considered when ascertaining whether a transaction is abusive include whether the substantive results of the arrangements are consistent with the underlying policy of the relevant provisions and any principles on which they are based, whether the means of achieving the tax advantage was contrived or abnormal, and whether the arrangement exploits any shortcomings in the legislation. The legislation sets out indications of when a transaction is likely to be abusive and includes cases where the tax position does not reflect the economic reality (for example, an interest expense is larger for tax purposes than what in actuality has been paid). Arrangements that accord with established and acknowledged H.M.R.C. practice will not generally fall foul of the G.A.A.R.

Before the G.A.A.R. is applied by H.M.R.C, an opinion of the "independent" Advisory Panel (technically part of H.M.R.C.) must be obtained. The Advisory Panel, comprising senior industry and business experts, opines only on the issue of whether a course of action undertaken by the taxpayer was reasonable in the circumstances. Any tribunal or court hearing an appeal on the G.A.A.R. must take into consideration the opinion given by the Advisory Panel.

The G.A.A.R. applies to tax arrangements entered into on or after July 17, 2013, although pre-commencement tax arrangements will be taken into account if this would render post-commencement tax arrangements not "abusive."

Where the G.A.A.R. applies, H.M.R.C will be entitled to counteract the tax advantage, for example, by denying a deduction for interest expense.

There is no provision to obtain a G.A.A.R.-specific clearance from H.M.R.C. that the G.A.A.R. does not apply, although, depending on the transaction type and circumstances generally, other clearances on similar purpose tests may be available.

Guidance on how H.M.R.C. interprets the G.A.A.R. (approved by the Advisory Panel), including worked examples, has been published on H.M.R.C.'s website.[12] Amongst other things, it confirms that arrangements that accord with making straight-forward choices, such as by funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, arrangements that are in accordance with long-established practice will also not be subject to the G.A.A.R. unless contrived.

Finance Act 2014 introduced provisions to empower H.M.R.C to issue "follower notices" and "accelerated payment notices" upon fulfillment of certain conditions to mandate the payment of any disputed tax upfront. "Follower notices" can in essence be used where a final judicial ruling in another case, relevant to the taxpayer's own case, has been delivered. "Accelerated payment" notices are intended for use in "tax avoidance" cases, where either a disclosure under the "disclosure of tax avoidance schemes" ("D.O.T.A.S.") legislation has been made or H.M.R.C. has issued a counteraction notice under the G.A.A.R. and certain other procedural steps are met. Late payment of the disputed tax amount may give rise to penalties, but if the taxpayer is ultimately successful in his case, H.M.R.C. will refund the tax paid with interest. Both measures have proved controversial with taxpayers, and the exact scope of each, and how they are applied in practice, remains to be seen.

FOREIGN ACCOUNT TAX COMPLIANCE ACT ("F.A.T.C.A.") – U.K. IMPLICATIONS

Background to U.K. Implementation of F.A.T.C.A. in Domestic Legislation

The U.S. government introduced F.A.T.C.A. as part of the Hiring Incentives to Restore Employment Act of 2010. Its primary function is to require financial institutions outside the U.S. to report information on U.S. account holders to the I.R.S., with the penalty for non-compliance being the "big stick" of a 30% U.S. withholding tax on payments made to them.

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[12] http://www.hmrc.gov.uk.

In the U.K., concerns were raised by the financial sector about the legal difficulties it would face complying with F.A.T.C.A. reporting, particularly in respect to U.K. data protection laws, and thus the potential impact of withholding on U.S.-source payments on the competitiveness of U.K. financial institutions ("U.K.F.I.").

In response, the U.K. government, along with the governments of France, Germany, Italy, and Spain, entered into discussions with the U.S. to address the implementation of F.A.T.C.A., resulting in the publication of a Joint Statement on February 8, 2012 setting out an agreement to explore an intergovernmental approach; and followed by the Model Intergovernmental Agreement to Improve Tax Compliance to Implement F.A.T.C.A. published on July 26, 2012.

The U.K. then moved to enter into a bilateral intergovernmental agreement (an "I.G.A.") based on this Model Agreement, which was signed on September 12, 2012, the first such I.G.A.

"Section 222 of Finance Act 2013 empowered the Treasury to make regulations giving effect to the U.K.-U.S. I.G.A. signed on September 12, 2012."

Implementation of the I.G.A.

Section 222 of Finance Act 2013 empowered the Treasury to make regulations giving effect to the U.K.-U.S. I.G.A. signed on September 12, 2012. Accordingly, the International Tax Compliance (United States of America) Regulations 2013,[13] which give effect to the U.K.-U.S. I.G.A., came into force on September 1, 2013. Any expression that is defined in the U.K.-U.S. I.G.A. but not in the Regulations is treated as having the same definition as in the I.G.A.

Implications of the I.G.A.

As a result of the U.K.-U.S. I.G.A.:

- F.A.T.C.A. withholding will be avoided on payments made to and by U.K.F.I.'s (although the position on pass-thru payments remains outstanding);
- U.K.F.I.'s will report the relevant F.A.T.C.A. information to H.M.R.C. instead of the I.R.S., designed as a mechanism to avoid the U.K. and E.U. data protection issues;
- U.K.F.I.'s F.A.T.C.A. reporting requirements will be aligned with existing domestic anti-money laundering processes as a way to reduce compliance costs and burdens;
- There will be a wider category of effectively exempt institutions and products; and
- There will be an element of reciprocity so that the U.K. receives something from the U.S. in return.

For financial institutions in the U.K. it is therefore intended that compliance with the U.S. Internal Revenue Code will be superseded by equivalent obligations under the U.K. I.G.A. and its implementing legislation, with the U.K., in the first instance, responsible for enforcement of these obligations, in place of U.S. withholding. Failure to comply with the U.K. rules will result in the financial institution having to comply with the primary U.S. F.A.T.C.A. legislation in order to avoid withholding.

[13] SI 2013/1962.

F.A.T.C.A. is particularly complex and its exact application can be uncertain. H.M.R.C. has published guidance in 2014 and 2015 about F.A.T.C.A., including information about which entities and which accounts fall within the reporting requirements of F.A.T.C.A. Most recently, in April 2015, H.M.R.C. published guidance stating that holding companies are no longer defined as "financial institutions" for the purposes of the regime. Instead, a new classification will be put in place based on the activities of the holding company. Further guidance as to the exact scope of the new classification and its implications for the relevant companies is still to be published, however. If a U.K. holding company is still obliged to comply to some extent with F.A.T.C.A. as implemented in the U.K., one should seek specific advice as the law remains in a relative state of flux.

U.K. GOVERNMENT ACTIVITY IN RELATION TO THE O.E.C.D.'S ACTION PLAN ON B.E.P.S.

In July 2013, the O.E.C.D. launched an action plan on Base Erosion and Profit Sharing (the "B.E.P.S. Action Plan"), identifying 15 specific actions needed in order to equip governments with the domestic and international instruments to address challenges to taxation in a borderless digital economy, whilst developing a new set of standards to prevent double non-taxation.

As part of Budget 2014, H.M. Treasury and H.M.R.C. published a position paper entitled "Tackling aggressive tax planning in the global economy: U.K. priorities for the G-20/O.E.C.D. project for countering Base Erosion and Profit Sharing," which sets out the steps that the U.K. government intends to focus on and take in order to develop the O.E.C.D. B.E.P.S. Action Plan.

The paper recognizes the need for international cooperation in combating tax avoidance and aggressive tax planning by multinational enterprises and states, that the U.K. will support the establishment of a clear and simple framework of rules that is effective for all parties concerned, and that is adaptable to suit developing business forms. The U.K., however, believes that these rules should not become an obstacle to its competitiveness in the global economy by, for instance, adversely impacting or advantaging some industrial sectors over others.

"In July 2013, the O.E.C.D. launched an action plan on Base Erosion and Profit Sharing."

Since the March 2014 position paper, the U.K. government has continued to support the O.E.C.D. in the furtherance of the B.E.P.S. Action Plan. In December 2014, the U.K. government announced two measures as part of the U.K.'s implementation of deliverables set out in the Action Plan. These were the introduction of country-by-country reporting and new rules to combat hybrid mismatches whereby, within a multinational group, either one party gets a tax deduction for a payment while the other party does not have a taxable receipt, or there is more than one tax deduction for the same expense. Enabling legislation to introduce country-by-country reporting was included in the Finance Act 2015, pursuant to which, once the legislation is introduced, multi-national companies with a U.K. parent company will be required to report annually to H.M.R.C. on their business in each tax jurisdiction in which they are active. A consultation on new rules to tackle hybrid mismatches was carried out between December 2014 and February 2015. A report on the responses to the consultation will be published by September 2015 and will be followed by a further consultation on proposed draft legislation. In both cases, the aim of the U.K.

legislation is to implement the O.E.C.D.'s recommendations in these areas as part of the B.E.P.S. Action Plan.

The U.K. government also pre-empted the O.E.C.D.'s recommendations with the introduction of the D.P.T. in April 2015. Some commentators considered that the D.P.T., which was introduced unilaterally by the U.K. government, risks undermining the B.E.P.S. Action Plan in this area, with the concern being that similar but conflicting and competing measures would be introduced without coordination in many jurisdictions, resulting in possible double (or worse) taxation. The U.K. government's published view, however, is that the D.P.T. is complementary to the B.E.P.S. Action Plan and consistent with its principles. The U.K. government further reiterated that it was fully engaged in the work to reform the international tax framework through the O.E.C.D. B.E.P.S. project.

SWITZERLAND

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IN GENERAL

In Switzerland, companies are generally taxed on federal, cantonal, and communal levels. Certain aspects of the Swiss system are often viewed to be unique for Americans. For example, the taxes are deductible in computing the taxable income. This affects the tax rate. Also, the cantonal/communal taxes, which are the functional equivalent of state taxes in the U.S., can be imposed at a rate that exceeds the federal rate.

The federal corporate income tax rate for ordinarily taxed companies is 8.5%, but because taxes are deductible, the effective federal income tax rate is 7.8%. The cantonal/communal corporate income tax rates depend on the company's location. The combined effective ordinary income tax rates (which include federal, cantonal, and communal taxes) vary among the cantons. The combined rates of tax are 12.2% in Lucerne, 12.66% in Appenzell, Ausserrhoden, Obwalden and Nidwalden, 14.60% in Zug, 21.15% in Zurich, and 24.17% in Geneva.

In addition to corporate income tax, capital taxes must be considered. It should be noted that there is no capital tax at the federal level. On the cantonal and communal levels, holding companies have to pay a reduced capital tax in the range of 0.001%-0.075%. The respective tax rates have been reduced dramatically in recent years, and in some cantons, the possibility exists to credit corporate income taxes against the capital tax.

TAXATION OF HOLDING COMPANIES

Corporate Income Tax

Subject to certain changes announced in an agreement with the E.U.,[1] a company that qualifies as a holding company for Swiss tax purposes is exempt from cantonal and communal corporate income taxes on most income – only income from Swiss real estate is ordinarily taxed. The main purpose of the holding company under its bylaws must be the holding and management of long-term financial investments in affiliated companies. Furthermore, to qualify as a holding company, one of two tests must be met. Either two-thirds of the company's total income must be derived

[1] On June 20, 2014, the Economic and Financial Affairs Council Ministers ("E.C.O.F.I.N."), which is responsible for E.U. economic policy and taxation, and the Swiss Federal Council approved a memorandum of understanding to abolish tax regimes that provide separate treatment for domestic and foreign income. In return, the E.U. has agreed to lift counter measures immediately following Switzerland's abolition of such regimes. For possible consequences see **Future Taxation of Swiss Holding Companies** at the end of this article.

from qualifying participations[2] or two-thirds of the assets reported on the company's balance sheet must be qualifying participations (at book values or, if possible, at higher fair market values).

A holding company is subject to ordinary taxation at the federal level (with an effective income tax rate of 7.8%). However, participation relief is available for (i) dividends from qualifying participations and (ii) capital gains from disposals of qualifying participations held for at least one year. The participation relief is not an outright tax exemption but rather a tax abatement mechanism. The corporate income tax liability will be reduced by the ratio of net dividend income (taking into account administrative and financing costs) to total net profit. As financing costs (*i.e.*, interest expenses) are considered for the calculation, high interest costs will lead to a dilution of the participation relief (*i.e.*, not a full exemption of dividends and capital gains).

"A holding company is subject to ordinary taxation at the federal level (with an effective income tax rate of 7.8%). However, participation relief is available for (i) dividends...and (ii) capital gains."

Capital Tax[3]

As previously noted, there is no capital tax at the federal level. In most cantons, holding companies pay a substantially reduced capital tax, *e.g.*, in the canton of Obwalden the capital tax for holding companies amounts to only 0.001% of the company's total net equity (at book value). Most of the other cantons have already reduced their capital tax.

The cantons may allow corporate income taxes to be credited against capital tax. Some cantons have already introduced this new system. However, as the credit is not refundable, no benefit is obtained if no corporate income tax is due.

Stamp Duty[4]

The issuance of new shares by and capital contributions to a Swiss-resident company (*e.g.*, a company limited by shares ("*Aktiengesellschaft*") or a limited liability company ("GmbH")) are subject to a one-time capital duty of 1% (issuances up to ₣1 million are exempt).

However, relief is available for stocks issued pursuant to a corporate restructuring, share-for-share acquisition, or inbound migration. For example, in a share-for-share acquisition, the issuer of new shares may benefit from the stamp duty exemption when (i) the acquiring company issues shares in consideration for the acquisition of shares of the target company and holds at least 50% of the shares in the target company after completion of the transaction and (ii) the tendering shareholders of the target company receive less than 50% of their total compensation for accepting the share-for-share exchange in the form of a consideration other than shares of the acquiring company (*i.e.*, cash or a credit/note). In further illustration, the transfer of a participation of at least 10% to another company would also qualify as a tax neutral restructuring and, thus, benefit from the stamp duty exemption.

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[2] A qualifying participation is one in which at least 10% of the nominal share capital or reserves are held or the fair market value of such participation is at least ₣1 million.

[3] Reductions in capital tax are within the scope of Swiss Corporate Tax Reform III. For possible consequences see **Future Taxation of Swiss Holding Companies**, below.

[4] Stamp duty is also within the scope of Swiss Corporate Tax Reform III. For possible consequences see **Future Taxation of Swiss Holding Companies**, below.

Value Added Tax ("V.A.T.")

A Swiss holding company may be subject to V.A.T. at the present rate of 8% if it provides services and receives management fees from affiliates or other service income in excess of ₣100,000 per year. V.A.T. may be recovered by the payer if it is a supplier of taxable goods and services. In addition, the holding company may be entitled to recover V.A.T. on payments made to others, such as consultants and auditors.

Securities Transfer Tax

The transfer of taxable securities is subject to securities transfer tax if those securities are transferred in exchange for consideration and at least one of the parties involved, or an intermediary, qualifies as a Swiss securities dealer. Certain transactions and parties are exempt. A "Swiss securities dealer" includes banks and bank-like financial institutions as defined by the Swiss banking law, investment fund managers, and Swiss companies holding securities with a book value exceeding ₣10 million. The securities transfer tax is 0.15% for Swiss securities and 0.3% for foreign securities (*i.e.*, 0.075% for Swiss securities and 0.15% for foreign securities applicable to each party that is not itself exempt or eligible for a specific exemption).

Swiss Withholding Tax[5]

Effective and constructive dividend distributions, including the distribution of liquidation proceeds in excess of the stated nominal share capital and capital contribution reserves (*i.e.*, capital surplus from contributions made by the direct shareholders), from Swiss companies are generally subject to a 35% Swiss withholding tax. The repayment of nominal share capital and capital contribution reserves are not subject to Swiss withholding tax. In principle, Swiss withholding tax due must be paid to the Swiss Federal Tax Administration, and the recipient of the distribution may claim a refund.

Under certain circumstances, a notification procedure allows for full relief from withholding tax, provided that the Swiss tax authorities are notified in advance of the payment and grant permission for such relief. The notification procedure applies to dividend distributions from a Swiss subsidiary to a Swiss parent company, provided that the beneficiary owns at least a 20% interest in its Swiss subsidiary.

A non-Swiss resident company may also be entitled to a full or partial refund of Swiss withholding tax on the basis of an applicable double tax treaty or, in the case of an E.U. parent company, the Swiss-E.U. Savings Tax Agreement. For example, dividends paid to any E.U. parent company may benefit from the notification procedure if the parent controls at least 20% of the Swiss subsidiary (or a lesser percentage, as provided by an applicable tax treaty). However, the E.U. parent company must obtain permission from the Swiss tax authorities prior to any dividend distribution in order to utilize this procedure.

If the parent company is based in the U.S. or in certain other countries, dividend distributions are subject to a reduced Swiss withholding tax (*e.g.*, 5% for the U.S.). The notification procedure should be available if the requirements of the relevant

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[5] Swiss withholding tax is within the scope of Swiss Corporate Tax Reform III. For possible consequences see **Future Taxation of Swiss Holding Companies**, below.

double tax treaty are met (*e.g.*, for the U.S. the parent company must hold at least 10% of all voting rights) and permission for partial relief at source has been obtained prior to any dividend distribution.

Tax Credit for Foreign Withholding Taxes

For non-refundable foreign withholding taxes, Switzerland provides a limited tax credit ("P*auschale Steueranrechnung*"). However, since Swiss holding companies are only subject to federal income tax, only one-third, at most, of the foreign tax can be credited. Moreover, the tax credit is limited to the federal tax payable in a certain tax period, unless steps are taken in advance to counteract this limitation. No tax credit is possible for income derived from qualifying participations benefitting from participation relief.

"Since 1962, Switzerland has had internal law measures in effect that are designed to prevent the misuse of double tax treaties."

Swiss Tax Treaty Network

Switzerland has income tax treaties with more than 80 countries, including all old and new E.U. countries and the majority of Switzerland's important trading partners. It has also entered into several limited treaties regarding sea and air enterprises.

1962 Anti-Abuse Decree

Since 1962, Switzerland has had internal law measures in effect that are designed to prevent the misuse of double tax treaties. The original legislation, herein referred to as the "1962 Decree," was revised at the end of 1998 and again in the course of 2010.

In general terms, the 1962 Decree characterized certain transactions as a misuse of the treaties because withholding tax in foreign countries was reduced, while Swiss tax was also reduced by certain transactions that minimized the tax base. Thus, the 1962 Decree provided that tax deductible payments by a Swiss entity had to be capped at 50% of the gross income that received withholding tax benefits under a double tax treaty. The 1962 Decree also mandated an annual minimum dividend distribution of at least 25% of the gross amount of its treaty protected income.

To illustrate the working of the 1962 Decree, assume that a Swiss holding company owned by foreign shareholders receives dividends, interest, and royalties from a subsidiary based in a third treaty country with which Switzerland has an income tax treaty in effect. Assume further that the total of those items of gross income is ₣100. In these circumstances, a maximum of ₣50 may be booked as a deductible expense paid to a third party outside Switzerland. In addition, a minimum dividend of ₣25 must be distributed to the Swiss company's shareholders.

1999 Circular Letter

The 1999 Circular Letter limits the application of the rules established under the 1962 Decree. Active Swiss companies, listed companies, and pure holding companies may transfer more than 50% of the gross treaty-protected income in the form of deductible payments if such payments are commercially justified. In addition, these companies are no longer forced to pay out a dividend of at least 25% of their gross treaty benefit income, if, at the level of the Swiss company, payment of Swiss withholding tax on the undistributed or hidden reserves is not endangered in the future.

The payment of Swiss withholding tax may be required if (i) the Swiss company has at least 80% foreign ownership, (ii) more than 50% of the assets of the Swiss company are situated outside of Switzerland (or are composed of claims against companies or individuals abroad), and (iii) the company does not pay an annual dividend of at least 6% of its net equity. All three conditions must be met before withholding tax is imposed at the full rates, notwithstanding the terms of an income tax treaty. In applying the asset test, shares in foreign companies may be viewed to be domestic assets. If this test is met, Swiss holding companies can avoid the minimum dividend distribution rule.

2010 Circular Letter

The 2010 Circular Letter limits the application of the 1962 rules (incl. circular letters) to double tax treaties that do not provide for a specific anti-abuse provision in the double tax treaty.

Special Rules for Companies with Contacts in the U.S.

Neither the 1962 Decree nor the Circular Letters of 1962, 1999, and 2010 are applicable in the context of a company having contacts with the U.S. The Swiss-U.S. double tax treaty of 1996 has overruled the application of the Swiss legislation with its extensive limitation on benefits provisions. Consequently, Swiss companies investing in the U.S. must look exclusively to the Swiss-U.S. double tax treaty in order to determine whether the treaty is being misused.

Holding Company Activities

In general, a Swiss holding company may be attractive because its functions are not strictly limited to holding activities. Thus, as long as (i) the main purposes of the holding company are holding activities (reflected in the articles and in practice) and (ii) either the income or the asset test, as described above in **Corporate Income Tax**, is met, the holding company can perform additional functions as follows:

- Financing of subsidiaries and other group companies;
- Holding and management of intellectual property; and
- Performance of management services within the group.

As a consequence, a Swiss holding company can employ personnel and it may rent office space. Due to cantonal and communal level tax exemptions, income derived from the foregoing activities (*i.e.*, interest, royalty, and management income) is only taxable on the federal level (whereby the effective tax rate is 7.8%). Nonetheless, because Swiss law does not contain a bright-line test, it is viewed as prudent to obtain a ruling from the tax authorities with regard to the substantial performance of functions other than holding company functions.

It has to be noted that discussions are under way regarding the tax exemption of certain holding company activities. At present, the outcome is unclear, but there may be consequences for the future taxation of Swiss holding companies (see **Future Taxation of Swiss Holding Companies**, below).

ADDITIONAL TAX-RELATED ISSUES

U.S. Check-the-Box Rules

In Switzerland, companies are, in most cases, incorporated either as an *Aktiengesellschaft* or as a GmbH. Since the Swiss *Aktiengesellschaft* qualifies as a *per se* corporation for the U.S. check-the-box rules, a check-the-box election may be made only for a Swiss GmbH. Swiss holding companies can be set up in the form of a Swiss GmbH (*i.e.*, no limitations on the amount of share capital).

Swiss Ruling Policy

Switzerland is well known for the generally cooperative and taxpayer-friendly ruling policy of its tax authorities. Advanced rulings can be obtained from the cantonal tax authorities with respect to cantonal, communal, and federal income taxes and from the federal tax authorities with respect to withholding taxes, treaty benefits and limitations, stamp duties, and securities transfer taxes.

All cases that do not clearly align with the tax codes or that are not based on a well-known government practice will generally be ruled in advanced.

Swiss Debt-Equity Rules

In 1997, the Swiss federal tax administration issued a detailed circular letter regarding the debt-to-equity ratios of Swiss companies. According to this circular letter, the minimum equity of company is calculated based on the maximum indebtedness of the assets of a company (which ranges between 15% and 30%). If a company has debt from related parties in excess of the required percentages (*e.g.*, 70% for participations), the company is deemed to be thinly capitalized for Swiss tax purposes. As a consequence, the excess debt will be considered as hidden equity for capital tax purposes. Interest payments on this debt are not tax deductible and will be re-qualified as deemed dividend distribution with respective Swiss withholding tax consequences.

Note, however, that a 2015 court decision approves the interest deductibility of higher amounts, if the taxpayer can prove that such payments meet the arm's length standard.

Use of Swiss Holding Companies

Compared to various E.U. Member States, a Swiss holding company has certain advantages:

- An activity clause is not required for investments (*i.e.*, participations owned by a Swiss holding company can also be qualified as portfolio investments);
- A "subject to tax clause" does not exist for underlying participations;
- In connection with dividend distributions, there is no holding period requirement for investments;
- There is no capital gains tax on the sale of participations of 10% or more;
- Income that is not dividend income is subject only to federal income tax (at the effective tax rate of 7.8%), whereas such income is fully taxable at rates between 30% and 40% in other E.U. Member States;

- Switzerland does not levy withholding tax on outbound royalties and outbound interest payments (with the exception of interest paid on bonds); and
- Switzerland does not have any C.F.C. legislation.

Future Taxation of Swiss Holding Companies

Within the framework of the third round of Swiss corporate tax reform, discussions are underway regarding the future taxation of Swiss holding companies. Such discussions reflect the E.U.'s criticism of certain Swiss tax practices, which began in 2007, and increasing international pressure on certain low- or no-tax rules.

On December 19, 2013, the Federal Council issued its final report on Swiss Corporate Tax Reform III and proposed measures that would alter several of the cantonal tax regimes. The most important changes may be the end of domiciliary and mixed companies and new rules regarding holding company regimes. However, alternative measures (*e.g.*, a patent box regime and lower general income and capital tax rates for Swiss companies) will also be introduced to ensure the competitiveness of the Swiss tax system.

Based upon the results of a survey in which all interested parties and other organizations were given the opportunity to submit commentary and opinions regarding the proposed legislation, it is now most likely that the following changes and amendments will be presented to the Swiss parliament for discussion:

- Abolition of domiciliary and mixed companies and changes to the holding company regime (most likely the above mentioned tax-free treatment of interest and other income will be ended);
- A tax free step up in basis on the company's tax balance sheet for all assets with undervaluation, in cases of domestication into Switzerland or in cases of a change of the tax status of a Swiss company (termination of a special tax status, like holding company status), and allowance of a depreciation method that uses the higher book values in the following five years.
- Introduction of a patent box company (it is unclear what direction such new legislation may take, but the Swiss government would like to introduce a flexible regime, which could always be kept in line with European legislation and practice);
- New reductions to cantonal and communal capital taxes;
- A general reduction of income tax for all companies on the cantonal and communal levels;
- Abolition of the stamp duty on capital (1% today, with certain exceptions); and
- Increased taxation on dividend income of Swiss resident individuals to a general rate of 70% of the dividends received (in lieu of various reductions, which exist today).

"Discussions are underway regarding the future taxation of Swiss holding companies...[that] reflect the E.U.'s criticism of certain Swiss tax practices."

On June 5, 2015, the Swiss federal council submitted the draft of new legislation in connection with Swiss Corporate Tax Reform III (including long explanations) to Swiss parliament for discussion hopefully during fall 2015 or spring 2016 the latest. The new legislation includes what has been described above but also makes clear that a previous proposal to introduce a tax on private capital gains is no longer under consideration.

THE NETHERLANDS

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Over the past few decades, the Netherlands has been a prime location for holding companies. The Netherlands was deemed to be so attractive that a number of countries have copied the Dutch participation exemption system with more or less success.

The main benefits of the Dutch holding company remain (i) access to an extensive tax treaty network, as well as access to a large network of bilateral investment treaties (each consisting of almost 100 treaties); (ii) the Dutch tax ruling practice; and (iii) the transparency of its holding regime. The importance of bilateral investment treaties that provide protection for investments by Dutch resident entities becomes apparent when jurisdictions enact defensive measures targeting foreign investors. The benefits of an extensive treaty network have been enhanced in the last few years with the popularity of the legal form of the so-called "Cooperative" ("*Coöperatie*") as a holding vehicle, allowing international holding structures to distribute profits free from Dutch dividend withholding tax.

CORPORATE INCOME TAX – GENERAL

In principle, all income of a holding company will be subject to Dutch corporate income tax at the rate of 25% for profits exceeding €200,000. Profits up to €200,000 are taxed at a rate of 20%. However, because of the Dutch participation exemption, a Dutch resident holding company will often have little or no taxable income.

PARTICIPATION EXEMPTION

In General

Under the participation exemption, as laid down in Article 13 of the Corporate Income Tax Act ("C.I.T.A."), dividends (including dividends in kind and "hidden" profit distributions) and capital gains derived from qualifying shareholdings are exempt from Dutch corporate income tax, while capital losses are deductible only under special circumstances (see **Capital Losses**, below.). No minimum holding period is required, although in a short term buy-and-sell transaction part of the tax exempt capital gain realized may be re-qualified as a taxable service fee. The participation exemption only applies if the interest held by the Dutch-resident taxpayer qualifies as a participation ("*deelneming*"). A participation exists if the Dutch taxpayer:

- Holds at least 5% of the nominal paid-up capital of a company with capital divided into shares;
- Holds an interest in an "open" limited partnership that gives entitlement to at least 5% of the profits realized by the open limited partnership;

- Holds at least 5% of the participating certificates of a fund for joint account;
- Is a member of a Cooperative; or
- Holds at least 5% of the voting rights in a company that is resident in an E.U. member state with which the Netherlands has concluded a tax treaty that provides for a reduction of Netherlands dividend withholding tax on the basis of voting rights.

In addition, if a Dutch holding company holds a qualifying participation in a subsidiary, under the so-called "drag along rule" a hybrid loan (see **Hybrid Loans and Profit Rights**, below) granted to that subsidiary or a profit sharing right in that subsidiary will qualify as a participation as well. If a Dutch taxpayer holds a shareholding of less than 5% in a company, or has granted a hybrid loan to a company or holds a profit sharing right in a company and a company related to the Dutch taxpayer holds a qualifying participation in that company, such smaller shareholding, hybrid loan, or profit sharing right will qualify for the participation exemption based on the so-called "pull along rule." Please note that the term "related" is statutorily defined and refers to share ownership of at least one-third (see also **Base Erosion**, below).

"The participation exemption does not apply to participations that are held merely as passive investments (the 'Motive Test')...[i.e.] the shareholder's objective is to obtain a return that may be expected from normal active asset management."

The participation exemption does not apply to participations that are held merely as passive investments (the "Motive Test"). However, if a participation does not pass the Motive Test, the participation exemption will nevertheless be applicable if (i) the participation is subject to a "realistic levy" according to Dutch tax standards (the "Subject-to-Tax Test") or/and (ii) the assets of the participation do not consist, directly or indirectly, of more than 50% of so-called "low-taxed free passive assets" (the "Asset Test").

Motive Test

In principle, a participation is considered to be held as a mere passive investment if the shareholder's objective is to obtain a return that may be expected from normal active asset management. If the shareholder has a mixed motive, the predominant motive is decisive. A participation is not considered to be held as a mere passive investment, if the business conducted by the participation is in line with the business of the shareholder. Furthermore, a participation held by a Dutch parent holding company that conducts an active management function for the benefit of the business activities of the group will pass the Motive Test. This is generally the case if the parent company fulfills – on the basis of its activities – a substantial role in the fields of administration, policy making, and financing for the benefit of the business activities of the group.

The foregoing also applies to Dutch intermediate holding companies. If a Dutch intermediate company carries out a linking function between the business activities of the (active) participation and the business activities of the (active) parent holding company, the participation of the Dutch intermediate company will pass the Motive Test.

The Motive Test is, in any event, deemed not to be met if the predominant function of the participation is to act as a group finance company or if more than half of the participation's consolidated assets consist of shareholdings of less than 5%.

Subject-to-Tax Test

The Subject-to-Tax Test will be met if the domestic tax system of the company in which a participation is held results in a realistic levy according to Dutch tax standards. This is generally the case if the subsidiary is subject to a profits-based tax at a regular statutory rate of at least 10%.

A tax system with tax base deviations, such as special investment deductions, different depreciation rules, or tax consolidation rules, does not necessarily fail the Subject-to-Tax Test. However, tax systems with base deviations caused by tax holidays, deductible dividends, and participation exemption regimes that are significantly broader than the Dutch system may fail the Subject-to-Tax Test.

Asset Test

The Asset Test stipulates that the taxpayer must demonstrate that the assets of the participation usually do not consist, directly or indirectly, of more than 50% low-taxed, free passive assets. For this purpose, the assets must be taken into account at fair market value. The term "usually" implies that the participation exemption remains applicable if the assets of the participation consist of more than 50% of low-taxed, free passive assets for a short period of time only.

Assets that qualify as free passive assets are as follows:

- Passive assets that are not necessary for the business activities of the entity holding the assets. Interest bearing bank accounts, loan receivables, and passive investments such as bonds and shares could, amongst others, qualify as free passive assets. In this respect it should be noted that real estate – including rights over real estate – is not considered to be a free passive asset, unless the real estate is held by a Dutch exempt investment institution or a Dutch 0%-taxed investment institution,
- Inter-company receivables, unless they are used by an active group finance company or are financed entirely or almost entirely (90% or more) by third-party debt; and
- Assets leased to a group company, unless they are used by an active group leasing company or are financed entirely or almost entirely (90% or more) by third-party debt.

As mentioned above, both directly and indirectly held assets of the participation must be taken into account. Consequently, assets of companies in which the participation holds an interest of at least 5% must be *pro rata* allocated to the participation. Interests below 5% are in any event deemed to be passive assets. Furthermore, if less than 30% of the assets held by a company consist out of low-taxed, free passive assets, all assets – excluding participations – of the company can be allocated to the participation as "good assets."

Free passive assets of the participation only qualify as "bad assets" if the assets are considered to be low-taxed. This is generally the case if the income derived from these assets is not subject to a realistic levy according to Dutch tax standards. In relation hereto, a similar approach to the Subject-to-Tax Test applies.

Earn-Out and Balance Guarantee Arrangements

Earn-out and balance guarantee arrangements agreed upon the sale of a qualifying participation are also covered by the participation exemption. Consequently, future payments or earnings under such arrangement are exempt from Dutch corporate income tax in the case of a Dutch purchaser of the participation and are nondeductible in the case of a Dutch seller.

Expiring Participation

If a qualifying participation falls below the 5% threshold as a consequence of a sale of shares or an issue of new shares to a third party, the participation exemption remains applicable for an additional period of three years, provided that the qualifying participation was held for an uninterrupted period of at least one year.

Non-Qualifying Participations

In the event that the shareholding is deemed to be a low-taxed portfolio participation to which the participation exemption does not apply, a credit system is available with respect to the income derived from that shareholding.

Stock Options and Convertible Bonds

Pursuant to case law, the participation exemption also applies to options that relate to shareholdings qualifying for the exemption. In addition, the Dutch supreme court ruled that a conversion gain realized on convertible bonds is covered by the participation exemption, if the conversion leads, or could lead, to a shareholding qualifying for the participation exemption.

Hybrid Loans and Profit Rights

As mentioned above, the participation exemption is also applicable to profit rights and hybrid loans held in combination with a qualifying participation. Loans will be treated as hybrid loans if:

- The interest on the loan is contingent on the profits of the borrower;
- The loan is subordinated to receivables of all other creditors; and
- The loan has a maturity of more than 50 years or has no maturity and is redeemable only upon bankruptcy, moratorium, or liquidation of the borrower.

"The participation exemption is also applicable to profit rights and hybrid loans held in combination with a qualifying participation."

If a loan qualifies as a hybrid loan, the loan will be regarded as capital for corporate income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporate income tax purposes and, in principle, will be subject to a 15% dividend withholding tax (for a further explanation regarding dividend withholding tax see below).

On the other hand, the interest and principal paid on a hybrid loan will be exempt from Dutch corporate income tax and Dutch dividend withholding tax in the hands of a Dutch resident lender if this lender owns a qualifying participation in the borrower or the borrower qualifies as a related entity of the lender (see **Base Erosion**, below). Especially in the context of international structures, we note that the exemption for interest received on a hybrid loan by a Dutch lender is not affected by the

tax treatment of interest paid by a nonresident borrower. Consequently, even if the foreign borrower is able to deduct the interest in its country of residence, the interest received will be exempt from Dutch corporate income tax.

Partitioning Reserve

Based on new legislation, taxpayers should form a so-called "partitioning reserve," if the taxpayer holds an interest in a company in respect of which a change in treatment (a "transition") occurs regarding application of the participation exemption. The purpose of this new legislation is to determine the taxable or exempt amount to be included in the partitioning reserve, in order to avoid double taxation and assure taxation at the moment of realizing a gain or a loss that originates in the period prior to the formation of the partitioning reserve.

At the time of the transition from an exempt period to a taxable period, or vice versa, the participation has to be re-valued at fair market value. The result of such re-valuation is included in the partitioning reserve. If the transition is from a taxable to an exempt sphere, a taxable partitioning reserve ("T.P.R.") is formed. In the case of a transition from an exempt to a taxable sphere, an exempt partitioning reserve is formed ("E.P.R."). This E.P.R. or T.P.R. will be released upon realization (*i.e.*, dividend distribution or capital gain). The new legislation will apply retroactively to all transitions as of January 1, 2007.

"Limitations apply to interest deductions arising from transactions that could be considered to result in base erosion for Dutch tax purposes."

OTHER ASPECTS

Costs and Expenses

Transaction expenses related to the acquisition and/or the sale of a participation are not deductible.

Base Erosion

Limitations apply to interest deductions arising from transactions that could be considered to result in base erosion for Dutch tax purposes. Interest paid on loans from related entities and individuals is not deductible insofar as the loans relate to:

- Profit distributions or repayments of capital by the taxpayer or a related entity to a related entity or related individual;
- Acquisitions by the taxpayer, or a Dutch-resident related entity or individual, of an interest in a company that is a related entity following the acquisition; or
- Contributions of capital from the taxpayer, or a Dutch-resident related entity or individual, to a related entity.

This rule prevents a Dutch taxpayer from deducting interest on borrowing to pay a dividend, to make an acquisition, or to make a contribution to capital. The base erosion provisions contain an exception under which the interest deduction will be granted if the taxpayer can demonstrate that:

- Both granting of the loan and the business transaction are based on sound business reasons; or

- The interest is subject to sufficient taxation in the hands of the recipient, and the recipient is not able to offset the interest income with losses from prior years or losses anticipated in the future, unless both the granting of the loan and the business transaction are not based on sound business reasons. Interest will be subject to sufficient taxation in the hands of the recipient if the recipient is taxed on profits determined under Dutch tax principles at a rate of at least 10%.

For the purpose of the base erosion provisions, an entity is deemed to be related if:

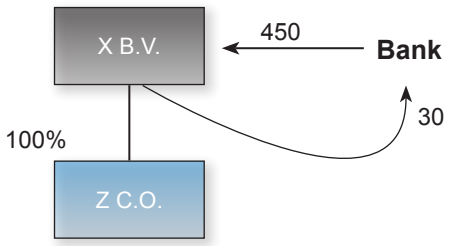
  - The taxpayer holds at least one-third of the capital in the other entity;
  - The other entity holds at least one-third of the capital of the taxpayer;
  - A third party holds at least one-third of the capital in both entities; or
  - The taxpayer and the other entity are part of the same fiscal unit for Dutch corporate income tax purposes.

Excessive Debt Financing for Holding Companies

On January 1, 2013, a restriction was placed on the deduction of "excessive" interest on loans taken up in connection with the acquisition and financing of participations qualifying for the Dutch participation exemption. The new Article 13L C.I.T.A. limits the deduction of interest on so-called "participation debt." Participation debt is defined as the difference between the cost of the participation and the taxpayer's equity for tax purposes. The interest that is proportional to the ratio of the participation debt and the company's total amount of debt is deemed to be excessive and nondeductible to the extent that the interest paid exceeds €750,000.

The limitation can be explained through the following example:

- X B.V. acquired a subsidiary ("Z C.O.") for €400 million and financed the acquisition and its ongoing activities with a bank loan of €450 million. X B.V.'s profits before interest expense amount to €25 million, and X B.V.'s interest expense is €30 million with respect to the bank loan. Normally, without applying Article 13L C.I.T.A., these figures result in a tax loss of €5 million (*i.e.*, €25 million in profits less €30 million in interest expense equals a €5 million loss).



- X B.V.'s balance sheet is as follows:

Debit	(€1 million)	Credit	(€1 million)
Participations	400	Equity	250
Other Assets	300	Debt	450

- Application of Article 13L C.I.T.A.:

  X B.V.'s participation debt amounts to €150 million (€400 million - €250 million). In principle, the interest payable with respect to this participation debt is nondeductible for Dutch corporate income tax purposes. In order to calculate the total amount of nondeductible interest, the participation debt (€150 million) must be divided by the total amount of debt (€450 million), the result of which should be multiplied by the actual interest expense (*i.e.*, 150/450 x 30 = €10 million). After taking the €750,000 threshold into account, a total amount of €9.25 million is characterized as nondeductible interest paid in relation to the acquisition of the participation. Consequently, in this example, the interest is deductible up to €20.75 million. The result is a taxable profit of €4.25 million (€25 million - €20.75 million) instead of a tax loss of €5 million, which would be realized without the application of article 13L C.I.T.A.

"Self-developed registered patents and certain other assets...may be placed in a so-called 'innovation box.'"

It should be noted that, for the calculation of the participation debt, investments in participations that are considered to be an expansion of the operational activities of the group can be excluded from the taxpayer's participations, which will result in a lower participation debt.

At the same time Article 13L C.I.T.A. was introduced, the Dutch thin capitalization rule was abolished, although a non-statutory debt-to-equity ratio is still applicable under certain circumstances (see **Tax Rulings**, below).

Dutch Acquisition Holding Company

Deductibility of interest expense is also limited for a Dutch acquisition holding company in connection with a loan taken up to acquire a Dutch target company that would be included with the acquiring entity in a fiscal unit for Dutch corporate income tax purposes post-acquisition. The benefit of establishing a fiscal unity structure is that the interest paid by the acquisition vehicle would be deductible from the profits of the target company. By forming a fiscal unit, the acquisition holding company would be deemed to absorb all assets and liabilities of the target company including its profits. Under Article 15ad C.I.T.A., interest paid by the Dutch acquisition holding company will only be deductible from the profits of that acquisition company, which generally would be negligible. The limitation applies only to the extent that the interest expense exceeds €1 million per year and the acquisition loan exceeds 60% of the acquisition price of the shares in the year of acquisition. In the following seven years, the loan should be repaid at a rate of 5% of the original principal per year, ultimately leaving an outstanding loan equal to 25% of the acquisition price. The nondeductible interest expenses can be carried forward. Article 15ad C.I.T.A. is applicable to both group loans and third-party loans. It also applies to post-acquisition legal mergers and liquidations within a fiscal unit. It seems however, that the adverse consequences of Article 15ad C.I.T.A. can be largely be avoided through the use of debt push-downs.

Innovation Box

In order to stimulate R&D activities by Dutch taxpayers, self-developed registered patents and certain other assets, apart from expensing costs related to R&D activities in the year incurred, for which a so-called "research and development statement" has been requested (collectively, "R&D Assets") may be placed in a so-called "innovation box." Pursuant to the innovation box regime, a 5% effective tax rate applies

to income generated by a qualifying intangible, to the extent the income from the intangible exceeds the related R&D expenses, other charges, and amortization of the intangible. Income includes royalty income such as license fees and other income stemming from R&D Assets. The taxpayer should be the registered and beneficial owner of the patents and the beneficial owner of the other assets for which a so-called "R&D statement" has been requested. Trademarks are specifically excluded from this beneficial regime. This 5% effective tax rate will only apply to qualifying income. The non-qualifying income will continue to be subject to tax at the statutory rates of 20% to 25%. The innovation box regime applies to income received from related and unrelated parties. The facility contains a threshold to prevent taxpayers from deducting expenses at the statutory rate while the corresponding earnings are taxed at the reduced effective rate of 5%. For this reason, the qualifying earnings should exceed the threshold before the effective tax rate of 5% can apply. The threshold is formed by the development costs of the intangible asset earmarked for the innovation box. The decision to use the innovation box should be made at the moment the corporate income tax return is filed.

Capital Losses

As mentioned above, if the participation exemption applies, a capital loss realized on, for example, the sale of a participation is generally not deductible. There is however one exception. Liquidation losses may be deductible under certain circumstances.

TAX RULINGS

In general, it is possible to obtain advance tax rulings, whereby the Dutch revenue authority confirms in advance the tax treatment of a holding company. A ruling will only be issued if certain substance requirements are met:

- At least half of the managing directors reside or are established in the Netherlands;
- The company's Dutch resident managing directors have sufficient professional knowledge to perform their duties;
- All management board meetings are held and prepared in the Netherlands and are in principle attended by all board members;
- The bank account(s) of the company are managed and maintained in/from the Netherlands;
- The bookkeeping of the company is done in the Netherlands; and
- The company finances its participations with a minimum of 15% equity.[1]

On June 11, 2014, the European Commission announced that it has opened an in-depth investigation to examine whether decisions by tax authorities in the Netherlands with regard to the corporate income tax of Starbucks comply with the E.U. rules on state aid. Similar examinations were opened regarding tax rulings in Ireland, with regard to Apple, and in Luxembourg, with regard to Fiat Finance and

[1] Even when an advance tax ruling is not obtained, it is advisable to maintain a (non-statutory) debt-to-equity ratio of 85/15.

Trade. According to a European Commission press release, the Netherlands generally seems to proceed with a thorough assessment based on comprehensive information required from the taxpayer. Hence, systematic irregularities in tax rulings are not anticipated. However, the tax ruling for Starbucks Manufacturing EMEA BV may provide that company with a selective advantage to the extent it is not in line with a market-based assessment of transfer pricing.

DIVIDEND WITHHOLDING TAX

Distributions of profits in any form by Dutch-resident entities, including limited liability companies, limited liability partnerships and other entities with a capital divided into shares, are subject to Dutch dividend withholding tax at a statutory rate of 15%. The rate may be reduced under an applicable tax treaty. Under certain conditions, the dividend withholding tax payable by the distributing Dutch holding company may be reduced by 3% in order to compensate for foreign withholding taxes that cannot be claimed as a credit by the holding company by virtue of the participation exemption. The Netherlands does not levy a withholding tax on royalties and interest, except with regard to interest paid on a hybrid loan (see **Asset Test**, above.).

The income tax treaty between the Netherlands and the U.S. provides, *inter alia*, for a full exemption from dividend withholding tax if the U.S. parent company owns 80% or more of the Dutch company and certain other requirements are met. If a U.S. parent company owns at least 10% of the shares of a Dutch company, dividends paid to the U.S. parent are subject to a 5% withholding tax. In all other cases, the dividend withholding tax rate is 15%.

No dividend withholding tax is levied on dividends paid to nonresident corporate shareholders, if:

- The corporate shareholder is a tax resident of a country within the E.U. or E.E.A.;
- The Dutch participation exemption would have been applicable to the shareholding in the Dutch entity distributing the dividends if the recipient of the dividends would have been a resident in the Netherlands;
- The corporate shareholder does not fulfill a similar function as a Dutch exempt investment institution or Dutch 0%-taxed investment institution; and
- The corporate shareholder is the beneficial owner of the dividends.

Finally, dividend withholding tax may be avoided altogether when a Dutch holding company is established in the form of a Cooperative because profit distributions by a Cooperative are not subject to dividend withholding tax unless anti-abuse rules apply (see **Extra-Territorial Taxation and Anti-Abuse Rules**, below). In comparison to a corporation, a Cooperative is neither a limited liability company nor a partnership, nor is it an entity with capital divided into shares. Consequently, dividend withholding tax is not imposed – again, unless anti-abuse rules apply (see **Extra-Territorial Taxation and Anti-Abuse Rules**). Nonetheless, a Cooperative qualifies as an entity under the E.U. Parent-Subsidiary Directive and is entitled to an exemption from foreign dividend withholding taxes on incoming dividends of qualifying participations in an E.U. subsidiary.

EXTRA-TERRITORIAL TAXATION AND ANTI-ABUSE RULES

It should be noted that although an exemption from withholding tax may be available (as described above under **Dividend Wittholding Tax**, above), the nonresident corporate shareholder of a Dutch holding entity may be subject to Dutch corporate income tax on the dividends received, if:

- The corporate shareholder owns 5% or more of the shares or a class of shares of the Dutch holding company;
- According to Dutch standards, the corporate shareholder does not conduct an enterprise to which the Dutch shares can be allocated; and
- The corporate shareholder holds the Dutch shares with the primary aim, or one of the primary aims, being to avoid the levy of Dutch income tax or dividend withholding tax with regard to its direct or indirect shareholders.

As stated above, profit distributions made by a Cooperative to its member(s) are, in principle, exempt from Dutch dividend withholding tax.

In line with the above-mentioned extra-territorial taxation, anti-abuse legislation was introduced for the Cooperative as well, in Article 1 of the Dutch Dividend Withholding Tax Act ("D.W.T.A."). This anti-abuse rule stipulates that a Cooperative will be treated as an entity with capital divided into shares for Dutch dividend withholding tax purposes, and profit distributions made by a Cooperative are subject to 15% Dutch dividend withholding tax in two circumstances:

- The first is that the Cooperative holds direct or indirect shareholdings or profit-sharing certificates or has granted profit participating loans with the primary aim, or one of the primary aims, being to avoid the levy of Dutch dividend withholding tax or foreign tax with regard to its direct or indirect members. In addition, the membership rights cannot be allocated to a member's enterprise.
- The second is that the membership rights are allocated to a member's enterprise, and the Cooperative is solely included in the structure for the purpose of avoiding an existing Dutch dividend withholding tax liability of a Dutch company.

These anti-abuse provisions are mainly aimed at individuals owning a Dutch holding company through an offshore entity. Active foreign companies and private equity funds owning international operations via a Dutch holding company will generally not be affected.

CAPITAL TAX AND STAMP DUTIES

The Netherlands does not levy any kind of capital tax, stamp duties, or other registration charges with respect to the issuance or transfer of shares in a Dutch resident company except, under certain circumstances, real estate transfer tax ("R.E.T.T."). R.E.T.T. is levied if a purchaser acquires real estate or at least one-third or more of the shares of a "real estate company." A company is considered a real estate company, if more than 50% of its assets consist, or consisted one year prior to the

acquisition, of real estate used for passive investment and at least 30% of its assets consist of Dutch real estate. R.E.T.T. is levied on the fair market value of real estate located in the Netherlands, with the consideration paid as a minimum. The applicable rate for residential real estate is 2%; 6% applies in all other cases.

B.E.P.S.

In an official statement regarding the first O.E.C.D. B.E.P.S. report released in September 2014, the Dutch government affirmed that it actively supports the initiatives taken by the G-20 and the O.E.C.D. to battle tax evasion. Implementation by the Netherlands of these initiatives is subject to international consensus on the proposed B.E.P.S. measures. However, a minor change has been made in relation to substance requirements currently only applicable to group service entities (*i.e.*, group financing and licensing companies) that wish to obtain a tax ruling. These substance requirements will also be applicable to group service entities that do not have a tax ruling. This decreases the possibility for such group service entities to claim tax treaty benefits. Implementation of measures directly related to the O.E.C.D. proposals is not expected before the O.E.C.D.'s approval of a multilateral instrument, which is expected by the end of 2016.

"The Dutch government affirmed that it actively supports the initiatives taken by the G-20 and the O.E.C.D. to battle tax evasion."

IRELAND

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The focus of Ireland's tax incentives has been to attract job creation activities. Typically, the incentives were in the manufacturing and financial services sectors, but they have now been extended to all trading activity. The rate of corporation tax on trading income is 12.5% where the trade is controlled or partly controlled from Ireland.

To complement this low rate, the Irish government has adopted policies to make Ireland an attractive holding company location.

The criteria for the ideal jurisdiction for holding companies would include the following:

- The absence of foreign withholding taxes on the payment of monies to a company located in the jurisdiction;
- A low rate of applicable tax;
- A developed tax network providing for full credit relief;
- A low or zero rate of capital gains tax on the disposal of associated companies;
- No withholding tax on payments from the jurisdiction; and
- Reduced foreign tax on dividends received from the jurisdiction.

Irish tax policy for attracting jobs through favorable tax rules may be affected by the O.E.C.D. report on base erosion and profits shifting ("B.E.P.S.") and the subsequent discussion draft documents addressed in the introduction. The B.E.P.S. report identified six key problem areas contributing to the growth of inappropriate profit shifting, including intra-group financial transactions, harmful tax regimes, and digital goods and services. To address these areas, the report proposed developing an action plan involving the O.E.C.D. and international tax authority stakeholders. The B.E.P.S. Action Plan was published in July 2013 with draft discussion documents on the various Actions having been published throughout 2014 and into 2015. Ireland already has many of the provisions considered in the B.E.P.S. report, such as a General Anti-Avoidance Rule, domestic provisions limiting tax relief on intra-group debt, transfer pricing legislation, and provisions taxing dividends from non-trading foreign subsidiaries at a higher rate of corporation tax than the headline 12.5% rate, but it is likely to have a particular interest in the discussion draft published on the tax challenges of the digital economy.

Overall, the Irish government's response to B.E.P.S. has been to welcome the O.E.C.D. initiative and the coordinated effort at the O.E.C.D. level to deal with the challenges B.E.P.S. poses. The stated position in Ireland is that the B.E.P.S. project cannot succeed without coordinated multilateral action. While Ireland sees the B.E.P.S. project as involving challenges, it also views it as offering a number of opportunities for small countries such as Ireland. This is because the Irish taxation system is built upon substance, and as such, the alignment of profits with substance, and a competitive rate of tax, accords well with concepts that have been the cornerstone of Ireland's corporation tax policy since the 1950's.

In addition, as mentioned elsewhere in this article, on June 11, 2014, the European Commission announced that it opened an in-depth investigation to examine whether decisions by tax authorities in Ireland with regard to the corporate income tax of Apple comply with the E.U. rules on state aid. Similar examinations were opened regarding tax rulings in the Netherlands with regard to Starbucks and in Luxembourg with regard to Fiat Finance and Trade. While a June deadline had been set for a decision regarding the Apple arrangements in Ireland, the European Competition Commissioner, Margrethe Vestager, announced in early May 2015 that this deadline would not be met. The Irish government has already hired a prominent U.K. Queen's Counsel and is prepared to take the Commission to the Court of Justice of the European Union, should it find Apple's Irish tax arrangements constituted an illegal State Aid.

"Overall, the Irish government's response to B.E.P.S. has been to welcome the O.E.C.D. initiative and the coordinated effort at the O.E.C.D. level to deal with the challenges B.E.P.S. poses. "

Largely as a pre-emptive action, taking into account international pressure (*e.g.*, B.E.P.S.), growing media interest, and Congressional hearings in the U.S., where Apple's operations in Ireland came under increasing scrutiny, the Irish government moved to bring an end to the so-called "double Irish" tax structure in the Finance Act 2014. As such, the "double Irish" has essentially gone through a change in Ireland's corporate tax residence rules (except in limited situations) for companies incorporated in Ireland on or after January 1, 2015, and for companies incorporated in Ireland before that date upon the expiration of a grandfathering period of six years. To offset the loss of the "double Irish" tax structure, the Irish government at the same time announced its intention to improve Ireland's intellectual property regime by putting in place a Knowledge Development Box ("K.D.B."). The stated aim of the Irish government is to establish a K.D.B. that is along the same lines as patent and innovative boxes in other countries competing with Ireland for foreign direct investment, which will be "best in class and at a low, competitive, and substantial tax rate." The Minister for Finance has, however, acknowledged that the timing and design of the K.D.B. will also depend on the views of the E.U. and the O.E.C.D.

CORPORATE TAX RATE

The Irish rate of corporate tax on trading income is 12.5%. The word "trading" is not defined in the legislation, but instead, reliance is placed on Irish and U.K. case law. The substantial volume of U.K. case law on this point is not binding upon Irish courts but is of persuasive value, depending on the seniority of the U.K. court. Broadly speaking, it is unlikely that the income of a pure holding company would qualify as trading income. It is more likely to be characterized as passive income, as it will be dividends, interest, and royalties from its subsidiaries.

The applicable rate of Irish tax on passive income is 25% (dividends, however, may be taxed at the 12.5% rate depending on the circumstances, as discussed in **Dividends Paid by Irish Holding Companies,** below). This rate of tax is low compared with other jurisdictions. In addition, Ireland's double taxation treaty network is likely to give a credit for overseas tax. In most cases, the credit will exceed the 25% rate of tax applied in Ireland, resulting in a zero liability to Irish tax. In the absence of a treaty between Ireland and the other jurisdiction, or where a treaty gives inadequate relief, Ireland's generous system of unilateral credit relief will reduce, if not eliminate, the Irish tax imposed on the income of a holding company.

DIVIDENDS RECEIVED BY IRISH COMPANIES

Dividends received by an Irish holding company from foreign subsidiaries do not qualify for a participation exemption as in many other holding company jurisdictions. Instead, Ireland operates a system of both treaty credit relief and unilateral credit relief, whereby credit for foreign tax is available against Irish tax on dividends received by an Irish holding company from certain foreign shareholdings.

The credit for foreign tax applies to dividends from a 5% shareholding in a foreign company, with the availability of a look-through to lower level subsidiaries where the relationship is at least 5% and the Irish company controls at least 5% of the lower tier company. The unilateral credit provisions apply to dividends received from all countries and not just E.U. Member States or countries with which Ireland has a double tax treaty.

Foreign dividends are subject to Irish tax at the rate of either 12.5% or 25%.

The 12.5% rate applies to dividends paid out of trading profits by certain companies:

- A company resident in an E.U. Member State or a country that has in effect a tax treaty with Ireland or that has ratified the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters; or
- A company that issued shares, or a 75% subsidiary of a company that issued shares, that are substantially and regularly traded on a stock exchange in an E.U. Member State or a country that has in effect a tax treaty with Ireland or that has ratified the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters.

Where dividends are paid by such a company on a shareholding of less than 5%, the dividends are deemed to have been paid out of trading profits, and so, the 12.5% rate will automatically be applicable. Where the profits of the company paying the dividend are at least 75% trading profits and meet either of the above conditions, a dividend will be deemed to be paid wholly out of trading profits, and so, the 12.5% rate will automatically be applicable once again. In other cases, an apportionment will be needed to determine the part of the dividend liable at the rate of 12.5% and the balance, which will remain liable at 25%.

The Finance Act 2013 introduced additional credit relief for tax on certain foreign dividends when the existing credit is less than the amount that would be computed by reference to the nominal rate of tax in the country in which the dividend is paid.

DIVIDENDS PAID BY IRISH HOLDING COMPANIES

When profits are extracted by way of dividends or other distributions from other European holding companies, difficulties can sometimes arise in relation to dividend withholding tax in the holding company jurisdiction. While dividends and other distributions made by an Irish holding company may be subject to Irish withholding tax, currently at the rate of 20%, there are a number of exceptions under domestic law that make the withholding tax less problematic in Ireland than in many other European holding company jurisdictions. An Irish holding company that is controlled directly or indirectly by persons resident in an E.U. Member State or in a country with which Ireland has in effect a double tax treaty should typically not suffer any withholding tax on dividend payments.

The Irish legislation implementing the E.U. Parent-Subsidiary Directive allows an Irish company to make distributions free of withholding tax to E.U. tax resident companies that comply with the conditions of the directive (*i.e.*, being a certain type of E.U. Member State company and paying tax in an E.U. Member State) and hold at least 5% of the share capital of the Irish company. No documentary requirements are needed in order for this exemption to apply.

Examples of recipients who can receive dividends and distributions free of dividend withholding tax include:

- A person, not being a company, who is neither resident nor ordinarily resident in Ireland and who is, by virtue of the law of an E.U. Member State or of a country with which Ireland has in effect a double tax treaty, resident for tax purposes in that country;
- A company that is resident in an E.U. Member State (other than Ireland) or in a country with which Ireland has in effect a double tax treaty, and which is not under the direct or indirect control of a person or persons resident in Ireland; and
- A company that (i) is neither a resident of Ireland nor a resident of any other E.U. Member State or a country with which Ireland has in effect an income tax treaty, and (ii) is under the ultimate indirect control of a person that is resident in an E.U. Member State (other than Ireland) or in a country with which Ireland has in effect a double tax treaty. Where there is a chain of ownership, the exemption does not apply if an Irish-resident company is in the chain.

"An Irish holding company that is controlled directly or indirectly by persons resident in an E.U. Member State or in a country with which Ireland has in effect a double tax treaty should typically not suffer any withholding tax on dividend payments."

There is no requirement for nonresident companies receiving dividends from Irish resident companies to provide tax residence and/or auditor certificates in order to obtain exemption from dividend withholding tax. Instead, a self-assessment system now applies, under which a nonresident company provides a declaration and certain information to the dividend-paying company or intermediary to claim exemption from dividend withholding tax. The declaration extends for a period of up to six years, after which a new declaration must be provided for the dividend withholding tax exemption to apply.

EXEMPTION FROM CAPITAL GAINS TAX ON THE SALE OF FOREIGN SHARES

An Irish tax resident company will be exempt from Irish corporate tax on its chargeable gains on disposal of shares, or assets related to shares, in certain subsidiaries. The current rate of tax is 33% on the disposal in the event that the exemption does not apply. However, an exemption from the tax is given where there is a disposal of shares (and assets related to such shares) in foreign companies and:

- At the time of the disposal the foreign company is resident for tax purposes in the E.U. or a treaty country (Ireland has signed double taxation treaties with 72 countries, of which 68 are currently in effect);
- The company making the disposal must be beneficially entitled, directly or indirectly, to at least 5% of the company's ordinary share capital, at least 5% of the profits available for distribution to the shareholders of the company, and would be beneficially entitled upon a winding up to at least 5% of the assets of the company available for distribution to shareholders;
- The disposal must occur during an uninterrupted period of 12 months during which the Irish company, directly or indirectly, holds at least 5% of the ordinary share capital of the company, is beneficially entitled to at least 5% of the profits available for distribution to the shareholders, and would be beneficially entitled upon a winding up to at least 5% of the assets of the company available for distribution to the shareholders of the subsidiary whose shares are being disposed of, or within 24 months of the last such uninterrupted period;
- At the time of disposal of the shares in the investee company (*i.e.*, the foreign subsidiary), either the investee company must carry on a trade, or the business of the investor company (*i.e.*, the Irish holding company), its subsidiaries, and the investee company and its subsidiaries, taken as a whole, consist wholly or mainly of trading; and
- The exemption does not apply to the disposal of shares deriving the greater part of their value from Irish land or buildings and certain other Irish assets.

FINANCING THE IRISH HOLDING COMPANY – INTEREST PAYMENT DEDUCTIONS

Ireland does not have thin capitalization rules. Therefore, an Irish holding company can be financed principally by way of debt. An Irish tax deduction is potentially available for interest on monies borrowed to finance the acquisition of shares. Interest is allowed as a deduction if it is used in acquiring any part of the ordinary share capital of (i) a trading company, (ii) a company whose income consists mainly of real estate rental income, or (iii) a holding company of such a trading or real estate rental company. A deduction is also allowed for interest on funds used to lend to such companies, which is used wholly and exclusively for the purposes of the borrower's trade or business or that of a company connected with it.

"If the Irish holding company is financed by way of debt, it will be required to pay interest to its lenders...However, there are numerous exemptions."

Certain conditions must be met in order for the interest deduction to be allowed. When the interest is paid, the Irish holding company must beneficially own, or be able to control, directly or indirectly, more than 5% of the company whose shares are being acquired or to whom the funds are being lent, or a company connected to it. During the period from application of the loan proceeds until the interest is paid, at least one director of the Irish holding company must be a director of such a company. The Irish holding company must also show that from the application of the loan until the payment of the interest, it has not recovered any capital from such a company, apart from amounts that are used to repay the loan in part or deemed under Irish rules to have been applied toward repaying the loan.

Care must also be taken that the anti-avoidance rules in relation to recovery of capital are not breached, which would jeopardize the deduction. In addition, anti-avoidance measures restrict the deductibility of interest where (i) intra-group borrowings are used to finance the acquisition of group assets and (ii) relief is claimed by way of an interest expense deduction on a borrowing to fund activities of related foreign companies. In such circumstances, the interest expense deduction may be denied where the relevant foreign income generated by the use of the loan proceeds is not remitted to Ireland.

Interest paid by an Irish company to a non-Irish resident that is a 75% parent can be characterized as a nondeductible distribution under Irish law. This re-characterization does not apply if the parent is tax resident in an E.U. Member State. If the parent is a resident of the U.S. for the purposes of the Ireland-U.S. Income Tax Treaty, a nondiscrimination article in the treaty should override the Irish domestic recharacterization.

In addition, an Irish company can elect to have the interest not treated as a distribution provided that (i) the company is a trading company, (ii) the payment is a distribution only because it is payable to a nonresident company of which the Irish company is a 75% subsidiary or associate, (iii) it is payable in the ordinary course of the Irish company's trade, and (iv) the payment would not otherwise be deductible.

FINANCING THE IRISH HOLDING COMPANY – INTEREST WITHHOLDING TAX

If the Irish holding company is financed by way of debt, it will be required to pay interest to its lenders. Interest paid by an Irish company to a nonresident of Ireland is subject to interest withholding tax, currently at the rate of 20%. However, there are numerous exemptions from the domestic withholding tax on payments of interest. Apart from the relief provided by the relevant treaty, an exemption exists under domestic law. Interest paid by an Irish holding company to a company that is resident in an E.U. Member State or a country that has in effect an income tax treaty with Ireland (*i.e.*, a "relevant territory") is exempt from the withholding tax (provided the relevant territory imposes a tax that generally applies to interest receivable in the relevant territory by companies from sources outside it), except where the interest is paid to such a company in connection with a trade or business carried out in Ireland.

TREATY NETWORK

Ireland has signed double taxation agreements with 72 countries of which 68 (listed below) are currently in effect:		
Albania	Greece	Poland
Armenia	Hong Kong	Portugal
Australia	Hungary	Qatar
Austria	Iceland	Romania
Bahrain	India	Russia
Belarus	Israel	Saudi Arabia
Belgium	Italy	Serbia
Bosnia & Herzegovina	Japan	Singapore
Botswana	Kuwait	Slovakia
Bulgaria	Latvia	Slovenia
Canada	Lithuania	South Africa
Chile	Luxembourg	South Korea
China	Macedonia	Spain
Croatia	Malaysia	Sweden
Cyprus	Malta	Switzerland
Czech Republic	Mexico	Thailand
Denmark	Moldova	Turkey
Egypt	Montenegro	United Arab Emirates
Estonia	Morocco	Ukraine
Ethiopia	Netherlands	United Kingdom
Finland	New Zealand	United States
France	Norway	Uzbekistan
Georgia	Pakistan	Vietnam
Germany	Panama	Zambia

Irish-resident companies are taxable on their worldwide income. The treaties avoid double taxation by providing for a credit for foreign tax imposed, whether directly or indirectly, on the income received by the Irish company. The credit is allowable only against the Irish tax on the same income. Notably, Irish domestic law grants a tax treatment more favorable than that given by the treaties. (See **Exemption from Capital Gains Tax on the Sale of Foreign Shares** above, in connection with tax credits for foreign dividends.)

CAPITAL DUTY

Capital duty is no longer imposed on a company with regard to share capital and certain other transactions.

STAMP DUTY ON SHARES

Stamp duty of 1% of the value is imposed on the transfer of shares in an Irish company, except transfers listed on the Enterprise Securities Market of the Irish Stock Exchange, once a commencement order has been issued by the Minister for Finance. This duty is only an unavoidable cost where the Irish holding company is also the ultimate company. On the other hand, where the Irish company is an intermediate holding company in the group, much can be done through exemptions and tax planning to claim relief from or to avoid the duty. The exemptions comprise the associated companies' relief and the reconstruction and amalgamation provisions that apply to group reorganizations.

LIQUIDATION DISTRIBUTIONS

If the holding company is liquidated, disposals by the liquidator will be deemed to be disposals by the company. Accordingly, exemption from capital gains tax on the disposal of shares in other companies is not lost solely by the holding company being put into liquidation.

The foreign shareholders in the liquidated company will not be liable to Irish capital gains tax except in the unlikely situation that the shares in the holding company derive their value from land in Ireland or certain other Irish assets (or, of course, if the shareholder is resident in Ireland).

THIN CAPITALIZATION, TRANSFER PRICING, & C.F.C.'S

Ireland has no C.F.C. rules. Apart from the recharacterization rules under which interest may be treated as a dividend and certain anti-avoidance provisions restricting interest deductibility in certain intra-group debt scenarios, Ireland does not have thin capitalization rules.

Limited transfer pricing legislation was introduced in 2010. Broadly, the legislation is only applicable to trading transactions between associated persons (effectively, companies under common control). It utilizes the O.E.C.D. guidelines on the basis of Article 9.1 of the model treaty. It does not apply to small and medium-sized enterprises. It applies to accounting periods commencing in January 2011 with respect to arrangements agreed on or after July 1, 2010.

RELEVANT ANTI-AVOIDANCE PROVISIONS

Ireland does not have relevant anti-avoidance provisions.

CONCLUSION

In the broader context of the E.U. Member States and other treaty countries, Ireland is a comparatively tax efficient location for a holding company. Generally, the negative factors disappear when Ireland is used as the jurisdiction for an intermediary holding company. The greatest tax benefit can be obtained when head office activity is carried out by the Irish company in addition to its role as a holding company.

SPAIN

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A Spanish holding company, or "*Entidad de Tenencia de Valores Extranjeros*" (familiarly known by its Spanish acronym "E.T.V.E."), is an ordinary Spanish company subject to 28% tax on its income (25% as of January 1, 2016), but fully exempt from taxation on qualified domestic- and foreign-source dividends and capital gains.

In addition to these standard features of a holding company, the E.T.V.E. regime offers a substantial advantage in relation to other attractive European holding company locations, as dividends funded from income earned from qualified foreign subsidiaries and distributed by the E.T.V.E. to non-Spanish resident shareholders are exempt from the Spanish withholding tax on dividends. In addition, capital gains triggered by a nonresident shareholder upon the transfer of an interest in an E.T.V.E. are not subject to the Spanish 20% capital gains tax (19% as of January 1, 2016) if the capital gains (indirectly) arise from an increase in the value of the qualified foreign holdings of the E.T.V.E.

The E.T.V.E. is protected by European Union directives such as the Parent/Subsidiary Directive and the Merger Directive and is regarded as a Spanish resident for tax purposes pursuant to Spain's 87 bilateral tax treaties.[1] Spain's extensive tax treaty network with Latin America, coupled with the European characteristics of the E.T.V.E., make it an attractive vehicle for channeling capital investments in Latin America as well as a tax-efficient exit route for European Union capital investments.

EXEMPTION ON QUALIFIED FOREIGN-SOURCE INCOME

The main tax feature of the E.T.V.E. is that both dividends obtained from qualified domestic and nonresident subsidiaries and capital gains realized on the transfer of the shares held by the E.T.V.E. in qualified domestic and nonresident subsidiaries are exempt from Spanish Corporate Income Tax ("C.I.T.").

The exemption applies subject to the fulfillment of specific requirements governing both the investments made by the E.T.V.E. and the E.T.V.E. itself.

QUALIFIED DOMESTIC AND FOREIGN INVESTMENTS

According to articles 107 and 21 of the C.I.T. Law, dividends and capital gains received by the E.T.V.E. from domestic and nonresident subsidiaries will be exempt from Spanish taxation if the following requirements are met:

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[1] An updated list of the tax treaties entered into by Spain is available here.

- The E.T.V.E. holds a minimum 5% stake in the equity of the subsidiary (and any second-tier subsidiary) or, alternatively, the acquisition value of the stake in the subsidiary exceeds €20 million.
- The E.T.V.E. directly or indirectly holds the stake in the subsidiary (and any second level subsidiary) for at least one year.
- The nonresident subsidiary is subject to, and not exempt from, a tax similar in nature to Spanish C.I.T. with a nominal rate of at least 10% (regardless of whether any exemption, deduction or any other tax advantage applies) and is not resident in a tax haven country or jurisdiction.

"The main tax feature of the E.T.V.E. is that both dividends... and capital gains... are exempt from Spanish Corporate Income Tax."

Minimum Stake and Holding Period

The equity of the subsidiary may be represented by shares, quotas, or other forms of capital interest. Dividends will be exempt at the level of the E.T.V.E. even if the one-year holding period requirement is satisfied after the dividends have been received. In comparison, capital gains will be exempt only if the one-year holding period requirement has been met on the date the transfer takes place.

The 5% stake requirement must be met by the E.T.V.E. on the direct and indirect holding of any first tier (or alternatively, the acquisition value of the stake in the first-tier nonresident subsidiary must exceed €20 million).[2]

If any first or lower-tier subsidiary derives more than 70% of its income from capital gains or dividends, the E.T.V.E. must indirectly hold at least 5% (*i.e.*, the €20 million holding rule does not apply to indirect holdings) of the share capital in all subsidiaries owned by the subsidiary that derive more than 70% of its income from capital gains or dividends. As an exception to this rule, if the directly held subsidiary that derives more than 70% of its income from capital gains or dividends and all its subsidiaries belong to the same group of companies pursuant to Spanish commercial law and prepare consolidated annual statements (and, on a consolidated basis, the 70% active income test is met), then the indirect stake will also qualify for the exemption if it exceeds €20 million.

For the purposes of calculating the time during which the E.T.V.E has held the stake, stakes are considered as held by a newly incorporated E.T.V.E. as of the date on which they were held by other companies within the same group.

Subject to and Not Exempt from Tax

The nonresident subsidiary must be subject to and not exempt from a tax of a nature similar to C.I.T. with a nominal tax rate of at least 10%, regardless of whether or not the nonresident subsidiary is entitled to apply any tax exemption, deduction, or any other tax advantage that correspondingly lowers the effective tax rate below 10%.

Determining the degree of compatibility between foreign tax systems and the Spanish C.I.T. is difficult. A tax of a similar nature will include any foreign tax levied on the income of the nonresident subsidiary, even if levied on a partial basis. For the purposes of this test, it is irrelevant whether the object of the foreign tax is the nonresident subsidiary's income, turnover, or any other index-linking element of the nonresident subsidiary. This requirement will be deemed to be met if the

[2] Investments made by an E.T.V.E. prior to January 1, 2015 will qualify for this regime for amounts exceeding €6 million.

nonresident subsidiary resides in a tax-treaty country, provided the treaty contains an exchange of information clause. It should be noted that all current treaties entered into by Spain contain exchange of information clauses.[3]

Finally, if a nonresident subsidiary is located in a country or territory deemed to be tax haven (as established by Royal Decree 1080/1991, as amended), it will not qualify for the E.T.V.E. tax exemption regime:[4]

Nonresident subsidiaries located in one of the following countries do not qualify for the E.T.V.E. exemption:		
Anguilla	Grenada	Monaco
Antigua & Barbuda	Guernsey	Montserrat
Bahrain	Isle of Man	Nauru
Bermuda	Jersey	Oman
British Virgin Islands	Jordan	Salomon Islands
Brunei	Lebanon	Seychelles
Cayman Islands	Liberia	St. Lucia
Cook Islands	Liechtenstein	St. Vincent & Grenadines
Dominica	Macau	Turks & Caicos
Falkland Islands	Mariana Islands	U.S. Virgin Islands
Fiji	Mauritius	Vanuatu
Gibraltar		

It must be pointed out that those countries or territories that enter into an exchange of information treaty or a tax treaty with an exchange of information clause with Spain will immediately cease to be deemed tax havens (unless such country is added to the list by decision of the Spanish tax authorities).

Active Nonresident Subsidiary

Effective as of January 1, 2015, the active nonresident requirement has been eliminated. However, capital gains arising from the transfer of non-active companies as described in article 5 of C.I.T.[5] will only qualify for the exemption up to the amount

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[3] This is an *iuris et de iure* presumption (*i.e.*, the Spanish tax authorities will not be entitled to provide rebutting evidence).

[4] This would not apply to nonresident subsidiaries resident for tax purposes in a tax haven country or jurisdiction within the E.U. (*e.g.*, Gibraltar) provided the E.T.V.E. can demonstrate to the Spanish tax authorities that the incorporation and operation of the foreign subsidiary in the tax haven is carried out for valid economic reasons and that the foreign subsidiary is engaged in an active trade or business.

[5] A company is considered non-active when more than half of its assets are made up of securities or not linked to active trade or business. Securities representing at least 5% of the share capital of a company which are held for a year are not taken into account for this purpose, so long as (i) the holding company holds

of the non-active company's retained earnings generated during the period of time that the E.T.V.E. has owned such a subsidiary. Excess capital gains will be taxable pursuant to the ordinary rules of the C.I.T. Law. Similarly, capital gains arising from the transfer of a nonresident company subject to the Spanish C.F.C. rules (see below) will not qualify for the exemption in any amount.

Qualified Holding Company

A Spanish company will qualify as an E.T.V.E. if the following requirements are met:

- The corporate purpose of the Spanish company includes, among other activities, the holding of stakes in operating nonresident entities.
- The Spanish company carries out its activities with the necessary human and material resources; bear in mind that non-active companies, as described in article 5 of the C.I.T. Law, will not qualify for the E.T.V.E. regime.
- The shares or quotas of the E.T.V.E. are in registered form. Pursuant to a ruling of the Spanish tax authorities, Spanish listed companies may opt for the regime.
- The Spanish holding company informs the Spanish tax authorities that it opts to be subject to the provisions of the Spanish holding company regime.

Corporate Purpose

The E.T.V.E. may carry out any activities, in Spain or abroad, in addition to holding stakes in nonresident companies. However, those activities will not be covered by the E.T.V.E. regime. Therefore, any profits derived from those activities will be subject to the general 28% C.I.T. tax rate (25% as of January 1, 2015) and the dividends distributed on those profits will be subject to the regular Spanish withholding tax regime. Please note that the participation exemption, as analyzed in the prior sections, will also apply to domestic dividends and capital gains, subject to the same described requirements.

"It is not necessary that the E.T.V.E. controls and manages the actual activities of the invested companies, but rather the stake itself."

It is not necessary that the E.T.V.E. controls and manages the actual activities of the invested companies, but rather the stake itself. The Spanish tax authorities have interpreted this requirement very flexibly.

Material and Human Resources

This requirement is closely related to the previous requirement.

The Spanish General Tax Directorate (the "D.G.T."), the administrative body in charge of drafting and interpreting tax legislation, clarified this essential requirement for E.T.V.E. in three non-binding rulings dated May 22, 2002, December 20, 2002, and March 31, 2004, and in one binding ruling handed down on October 29, 2003.

The D.G.T. takes the view that the proper human and material resources requirement is met, *inter alia*, if the day-to-day management of the E.T.V.E. is vested in one or more directors of the company who has been granted sufficiently broad powers

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the stake with the aim of managing and controlling its interest in the subsidiary with the necessary human and material resources and (ii) the subsidiary is not a non-active company.

of attorney to allow him/her to manage the E.T.V.E., provided that the director is resident in Spain for tax purposes. Day-to-day activities include the performance of accounting, tax, and legal obligations required for the fulfillment of the corporate purpose of the E.T.V.E. Conversely, the D.G.T. has expressly stated that if those services are completely outsourced, it will be deemed that the company does not fulfill the "human and material resources" requirement.

Finally, it should be noted that all D.G.T. rulings are framed within the context of the E.U. Code of Conduct and the E.C.O.F.I.N. Council's goal of eliminating harmful tax competition within the E.U. Moreover, specific decisions of courts in other European countries – such as the decision of the Tax Court of Cologne of June 22, 2001 – interpret "substance" using similar reasoning.

"Dividends distributed by the E.T.V.E. to nonresident shareholders out of qualified exempt income... will not be subject to the Spanish dividend withholding tax."

Filing with the Spanish Tax Authorities

The E.T.V.E. must notify the Spanish tax authorities of its intention to apply the holding company tax regime. In addition, the Spanish holding company may submit binding ruling requests on the interpretation of the regulations and requirements of the regime. The special tax regime will come into effect in the fiscal period of the E.T.V.E. ending after the notice is filed.

Deduction of Costs

The value of a stake in the nonresident subsidiaries may be recorded for accounting and tax purposes under the general C.I.T. rules applicable to all Spanish-resident companies. Financing expenses connected with the participation are tax deductible within the new limits on the deduction of financial expenses set out by the Spanish Government in March 2012 and January 2015, as explained in **Corporate Income Tax**, below. Foreign exchange gains and losses are taxable or deductible.

LIQUIDATION LOSSES

A loss realized upon the liquidation of a nonresident subsidiary is deductible, although limited to the amount that exceeds any dividend received from the nonresident subsidiary declared exempt as of 2009 and that did not reduce the book value of the nonresident subsidiary in the E.T.V.E.'s accounting records.

Furthermore, if the E.T.V.E. successively disposes of and acquires homogeneous securities (*e.g.*, shares in the same company), capital losses accrued will be reduced by the amount of the capital gains previously obtained in the transfer of those homogeneous securities that benefited from the exemption.

EXEMPTION OF E.T.V.E. DIVIDEND DISTRIBUTIONS

Dividends distributed by the E.T.V.E. to nonresident shareholders out of qualified exempt income (*i.e.*, dividends and capital gains that were exempt from tax at the level of the E.T.V.E.) will not be subject to the Spanish dividend withholding tax. However, the dividend withholding exemption does not apply to nonresident shareholders resident in a tax haven country or territory, as established by Royal Decree 1080/1991 (and listed above).

Otherwise, dividends distributed by the E.T.V.E. will be subject to the standard 20% withholding tax (19% as of January 1, 2016) or the reduced bilateral tax treaty rate, as applicable.

Dividends paid by the E.T.V.E. to its E.U.-resident shareholder will not be subject to the dividend withholding tax in any case if the E.U. shareholder:

- Takes one of the forms set out in the Annex to the Parent/Subsidiary Directive;
- Is subject to, and not exempt from, tax as listed in article 2.c) of that Directive;
- Owns directly at least 5% of the share capital of the E.T.V.E.; and
- Has held the stake for at least 12 months immediately preceding the dividend payment, or continues to hold the participation until the one-year period is completed (in the latter case, the withholding will be levied upon distribution and the E.U.-resident shareholder will be entitled to claim a refund once the one-year holding period has elapsed).

Certain anti-abuse rules may apply when the stake in the E.U.-resident shareholder is mainly held, directly or indirectly, by persons who are not tax resident in an E.U. Member State.

In addition, in line with several binding rulings issued by the Spanish tax authorities, exempt income earned through an E.T.V.E.'s foreign permanent establishment would be treated as qualified exempt income of the E.T.V.E. when earned (in the form of dividends or capital gains) by its nonresident shareholder.

CAPITAL GAINS ON TRANSFER OF E.T.V.E.

Capital gains triggered by non-Spanish resident shareholders on the disposal of Spanish shares are normally subject to a 20% tax (19% as of January 1, 2016).

However, there is a specific exemption available to non-Spanish resident shareholders, on gains resulting from the disposal of shares in a E.T.V.E. Capital gains triggered by nonresident shareholders, other than a tax haven company, upon the (i) transfer or full amortization of its stake in the Spanish holding company or (ii) liquidation of the Spanish holding company will not be subject to the Spanish capital gains tax to the extent that the capital gain is equivalent to (a) the existing reserves (from qualified foreign source exempt income) of the Spanish holding company or (b) a difference in value of the stake in the foreign subsidiaries of the Spanish holding company, if the stake fulfills the requirements described above during the entire holding period.

Also, in a tax treaty context, a capital gain on the disposal of shares in the E.T.V.E. will generally not be subject to Spanish taxation. Some tax treaties ratified by Spain, such as that with the U.S.,[6] allow Spain to tax capital gains at the general 20% tax

[6] On January 14, 2013, the U.S. and Spain signed a new protocol amending the current 1990 tax treaty for the avoidance of double taxation. This new protocol includes significant changes to foster the efficiency of reciprocal direct investment in the U.S. and Spain. In particular, it brings withholding treaty

rate (19% as January 1, 2016), provided that the foreign shareholder holds a substantial stake in the Spanish entity (usually more than 25% of the capital).

Finally, there are some additional domestic exemptions available to E.U.-resident shareholders, who will also benefit from an exemption on capital gains triggered by the disposal of the stake in the E.T.V.E. (or any other Spanish resident company). The exemption applies when (i) the E.T.V.E. does not mainly derive its value, whether directly or indirectly, from real estate located in Spain; and (ii) in the case of an E.U.-resident natural person, if the latter has not held at any time during the 12-month period preceding the disposal of the interest a stake in the capital of the E.T.V.E. an equity interest of 25% or more; or (iii) in the case of E.U.-resident legal persons, when the participation-exemption requirements set out in article 21 of the C.I.T. Law, as previously explained, are met with respect to the E.T.V.E.

LIQUIDATION OF AN E.T.V.E.

The liquidation of an E.T.V.E. triggers a capital gain not subject to withholding tax and taxable as described in this article under **Exemption of E.T.V.E. Dividend Distributions**. The liquidation will also trigger capital duty unless specific, special provisions apply (see below).

OTHER INCOME TAX ISSUES

In recent years, the Spanish tax authorities have challenged tax deductions claimed by Spanish-resident corporate taxpayers for interest-related expenses on intra-group debt resulting from an acquisition of subsidiaries forming part of the same group of companies. The basic claim in those cases was that the intra-group reorganization was "tax abusive" (*i.e.*, lacking a business purpose).

In 2012, the Spanish parliament ring-fenced the use of these potentially abusive schemes by enacting Royal Decree-Law 12/2012, amending the Spanish C.I.T. Law. For C.I.T. purposes, the Decree prohibits deductions for financial expenses on intra-group indebtedness incurred to: (i) acquire an interest in the share capital or equity of any type of entity from another group company or (ii) increase the share capital or equity of any other group companies. Taxpayers are permitted to avoid the disallowance if it is proven that sound business reasons exist for the transaction.

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rates and other provisions in line with the tax treaties in force between the U.S. and the most economically and politically important European Union countries, effectively eliminating the need for complex and costly investment planning structuring.

In most cases, the protocol eliminates taxation at source, creating significant savings and increasing net yields. Capital gains will only be taxed at source on the disposal of real estate and real estate holding companies (subject to certain requirements).

The protocol also reinforces technical mechanisms to avoid double taxation through Mutual Agreement Procedures ("M.A.P.'s") and provides for arbitration to resolve tax issues. The treaty's exchange of information clause is updated to current standards.

At the present time, the U.S. Senate's consideration of new tax treaties and protocols has been blocked over concerns regarding confidentiality of information given to non-U.S. tax authorities.

Royal Decree-Law 12/2012 does not define "sound business reasons" for these purposes, but nevertheless states in its preamble that a group restructuring that is a direct consequence of an acquisition from third parties (which could include specific debt push downs), or situations in which the acquired companies are actually managed from Spain can be deemed reasonable from an economic perspective.

CORPORATE INCOME TAX

Rate

An E.T.V.E. is subject to the 28%[7] Spanish corporate income tax on income other than qualified dividends and capital gains, as previously explained.

Interest Barrier Rule

Royal Decree-Law 12/2012 has replaced the thin capitalization rules with a general restriction on the deduction of financing expenses. The scope of thin capitalization rules was limited in cross-border transactions because they did not apply to debts with residents in the E.U. Decree 12/2012 establishes that net financing expenses exceeding 30% of the operating profit (subject to specific adjustments) of a given tax year will not be deductible for C.I.T. purposes. Financing expenses in excess of the ceiling can be carried forward and deducted in future tax periods, much like net operating loss carryovers. Net financing expenses not exceeding €1 million will be tax deductible in any case.

"Net financing expenses exceeding 30% of the operating profit (subject to specific adjustments) of a given tax year will not be deductible for C.I.T. purposes."

In addition, Law 27/2014 of November 27 introduced new limits on the tax-deductibility of interest arising from leveraged buyouts. In particular, the tax-deductibility of interest paid in consideration of a debt incurred in order to acquire the shares in a company is limited to 30% of the acquiring company's E.B.I.T.D.A. (as defined in the C.I.T. Law), disregarding for this purpose the E.B.I.T.D.A. corresponding to any company that merges with the acquiring company or joins the same tax group as the acquiring company within the four-year period following the acquisition. This limit does not apply if at least 30% of the acquisition is financed with equity and the debt incurred is reduced every year by at least the proportional part required to reduce the debt to 30% of the acquisition price in eight years, until this level of debt is reached.

Capital Duty

The raising of capital by a Spanish company is exempt from capital duty. Likewise, the transfer of the seat of management of a foreign entity to Spain does not trigger capital duty. Reduction of share capital and dissolution of companies remain subject to 1% capital duty.

In addition, specific corporate reorganizations are not subject to capital duty if the corresponding requirements are met.

Finally, the incorporation of a Spanish company will trigger notary fees and registration costs equivalent to approximately 0.05% of the total committed capital.

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[7] In June 2014, the Spanish Government announced a two-step reduction of the 30% C.I.T. rate in force at that time, which will be lowered to 25% by 2016. In addition, various tax deductions and allowances will be significantly amended or removed.

Transfer Pricing

According to the Spanish C.I.T. Law, Spanish companies are obliged to assess transactions with related parties (defined in article 18.2 of the C.I.T. Law) on an arm's length basis. In order to determine the fair market value of the transaction, and following the O.E.C.D. guidelines, the law stipulates that the parties may use any of the following methods: the comparable uncontrolled price method, the cost plus method, the resale price method, the profit split method, or the transactional net margin method.

"The E.T.V.E., as any other Spanish-resident company, is subject to C.F.C. rules, the Transparencia Fiscal Internacional."

Additionally, the parties must produce and maintain appropriate documentation to demonstrate to the Spanish tax authorities the valuation used. This obligation is not applicable for certain entities and transactions that fulfill some requirements.

The tax authorities are entitled to impose penalties in two situations. The first is when the taxpayer does not comply with the documentation obligations. The second is when the taxpayer complies with the documentation obligations but the value of the transaction used by the taxpayer is not that resulting from the documentation provided to the authorities. Thus, if the valuation used in transactions with related parties is consistent with the documentation provided to the authorities, even if the tax authorities disagree with the resulting valuation, the tax authorities will not be entitled to impose penalties.

Finally, in order to resolve the issue of transfer pricing on a preliminary basis, the C.I.T. Law establishes the possibility of submitting a preliminary proposed valuation of transactions between related parties to the authorities (*i.e.*, an Advance Pricing Agreement or "A.P.A.").

The Spanish C.I.T. regulations detail the procedure for resolving proposals that related parties submit to the tax authorities.

Taxpayers must submit detailed documentation together with specific proposals, depending on the type of A.P.A.

With respect to international transactions, the regulations lay down a special procedure for a four-party agreement between the Spanish tax authorities, the tax authorities of the other country, and the taxpayers themselves for determining the assessed value of a transaction between related parties.

Spanish tax authorities have been encouraging taxpayers to submit advance pricing proposals and, although it must be said that taxpayers and tax authorities are not accustomed to addressing preliminary agreements (unlike in other jurisdictions), the tax authorities seem to be very willing and flexible in their stance.

Controlled Foreign Corporation

The E.T.V.E., as any other Spanish-resident company, is subject to C.F.C. rules, the *Transparencia Fiscal Internacional*. Under the C.F.C. rules, specific income generated by a foreign entity can give rise to C.I.T. for the E.T.V.E. if: (i) the E.T.V.E. has a minimum 50% stake in the entity's capital, equity, profits and losses, or voting rights; (ii) the income is subject to a tax lower than 75% what would have been due under Spanish C.I.T. that would have been payable; and (iii) the income is tainted income (such as financial income, dividends, passive real estate income, royalties, and the like).

In addition, if conditions (i) and (ii) are met and the foreign entity does not have the necessary human and material resources available to carry out its activity, all its income will be considered tainted.

The E.T.V.E. is not required to recognize tainted income obtained by its E.U. affiliates to the extent that the E.T.V.E. can demonstrate to the Spanish tax authorities that the incorporation and operative of the E.U. affiliate is carried out for valid economic reasons and that the E.U. affiliate is engaged in an active trade or business.

Recent B.E.P.S. Developments

The new corporate income tax law that entered into force for tax periods starting in 2015 has introduced certain B.E.P.S.-inspired measures, mainly seeking to address hybrid instruments and payments. In particular:

- Interest paid on intra-group profit participation loans will be treated as equity instruments for tax purposes, will no longer be tax deductible for the borrower, and will be tax-exempt for the Spanish-resident lender. The tax treatment for the non-Spanish resident lender remains unclear;
- Interest and other expenses accrued with respect to payments to related parties will not be tax deductible for the Spanish resident payer if, as a result of an alternative characterization of the payment, the recipient of the payment does not recognize any taxable income, or such income is exempt from tax or taxed at less than 10% nominal rate; and
- Dividends received from foreign subsidiaries will not be entitled to the participation-exemption to the extent the dividend distribution has triggered a tax-deductible expense in the foreign subsidiary.

BELGIUM

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Belgium does not provide a privileged tax regime for holding activities (such as the former 1929 Luxembourg holding company). However, a Belgian company subject to Belgian corporate income tax or a Belgian branch of a foreign company is eligible, under appropriate circumstances, for benefits of the Belgian participation exemption, which provides a favorable tax regime for dividends and capital gains from the disposition of shares of stock in subsidiary corporations. However, since the regulations were amended in 2007,[1] the Private P.R.I.C.A.F. offers certain opportunities as an investment vehicle for collective investment in equity (shares).

This portion of the paper focuses on the Belgian company as a holding company, but under certain circumstances, a Belgian branch of a foreign company could be a valuable alternative. The most significant advantage of a branch would be that there is no dividend withholding or "branch profits" tax due on the repatriation of branch income to the head office.

CORPORATE INCOME TAX

General Regime

A Belgian company is subject to corporate income tax on its worldwide profit. For corporate income tax purposes, the taxable profit is determined, in principle, on the basis of the commercial accounts (*i.e.*, standalone Belgian G.A.A.P. accounts; statutory accounts based on I.A.S. or I.F.R.S. cannot be utilized for Belgian corporate tax purposes). The general corporate income tax rate in Belgium amounts to 33.99% (including a 3% austerity surcharge).

Participation Exemption – General

Under the participation exemption, qualifying dividends received by a Belgian company are eligible for a 95% deduction, and capital gains realized on the disposition of qualifying shares of stock are eligible for either a 100% exemption (if the recipient company qualifies as a Small or Medium-sized Enterprise or "S.M.E."[2]) or taxation

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1 Royal Decree of May 23, 2007.

2 The notion of "Small or Medium-sized Enterprise" is defined in the Code on Company Law and the criteria are adjusted from time to time. At the time of this writing, a company is required to satisfy the following tests in order to qualify as an S.M.E.: (i) average number of employees ≤ 50; (ii) turnover (*i.e.*, sales) ≤ €7,300,000 (*per annum*); and (iii) balance-sheet total ≤ €3,650,000. When only one out of three tests is failed, the taxpayer still qualifies as an S.M.E., unless the taxpayer employs over 100 employees, in which case the taxpayer no longer qualifies as an S.M.E., even if it satisfies tests (ii) and (iii). If the taxpayer is part of a consolidated group, the thresholds are tested on a consolidated basis.

at a special rate of 0.412% (for other corporate recipients). However, if the one-year holding period requirement is not met, capital gains are taxed at a special flat rate of 25.75%.

Dividends Received Deduction

The full amount of all dividends received – net of foreign withholding tax – is first included with all other taxable income items of the Belgian company. Subsequently, 95% of qualifying dividends are deducted, but only to the extent that the initial computation results in a positive balance. In principle, the remaining 5% of dividends received will be part of the taxable income of the Belgian company. If, in the current year, the net result of the Belgian company's other activities is negative, none or only part of the qualifying dividends can be deducted. Moreover, in certain instances, any negative result of the Belgian company derived from other activities may be wholly or partially "absorbed" by dividends qualifying for the participation exemption. In those instances, the absorbed portion of operating losses is not eligible for carryover to subsequent tax years. The "unused" portion of the dividends received deduction would then be permanently lost, as no carryforward or carryback is available. While this was the general rule until the *Cobelfret* case was decided (see below), the situation is now more nuanced.

The E.C.J. delivered a ruling in *Cobelfret v. Belgium*, case C-138/07, on February 12, 2009. In line with the Advocate General's opinion of May 2008, the E.C.J. concluded that Belgium failed to refrain from taxing qualifying dividends, as is required under Article 4(1) of the E.U. Parent-Subsidiary Directive. Two other cases were decided by "reasoned order" of the E.C.J. on June 4, 2009 (*KBC v. Belgium*, case C-439/07 and *Beleggen, Risicokapitaal, Beheer NV*, case C-499/07) and dealt not only with E.U.-source dividends, but also with Belgian domestic dividends as well as third-country dividends. In its order, the E.C.J. referred the matter back to the Belgian national tax courts because the E.C.J. did not see a direct infringement of E.U. rules. Consequently, the national courts must decide whether there is discrimination in the treatment of nonresident taxpayers compared with resident taxpayers. Pursuant to the outcome of the *Cobelfret* case, the statute was amended by the Law of December 21, 2009, effective January 1, 2010. The position can now be summarized as follows.

Unused portions of the dividends received deduction can be carried forward for use in future tax years only if, at the time the dividend is declared, the dividend-distributing company is established:

- In a Member State of the European Economic Area ("E.E.A."), including Belgium, although for dividends declared before 1994, non-E.U. Member States of the E.E.A. are not taken into consideration, as the E.E.A. entered into effect on January 1, 1994;
- In a country with which Belgium has concluded a bilateral tax treaty that contains an equal treatment clause (functional equivalent of Article 22(1)(c) of the Belgium-U.S. Income Tax Treaty currently in effect); or
- In another country, provided that Article 56 of the Treaty of Rome applies (free movement of capital – Article 63 of the Treaty on the Functioning of the European Union, or "T.F.E.U.") to the (share) capital represented by the shares that produce the dividends.

In addition, Belgium disallows the dividends received deduction for dividends received by a Belgian company to the extent that its taxable income (*i.e.*, profit) consists of certain nondeductible expenses. However, according to Article 205, §2, Sections 2 and 3 I.T.C., the disallowance does not apply to dividends stemming from qualifying subsidiaries established in E.U. Member States. In its Circular Letter of May 19, 2010, the carve-out was extended to dividends from sources mentioned in the first two bullets above. Pursuant to Article 45 of the Law of April 14, 2011, the non-applicability of the disallowance for qualifying E.E.A.-source dividends is enshrined in the statute.

"A minimum holding period of one uninterrupted year is required in order for the dividends received deduction to apply."

According to a ruling of February 1, 2011 from the Tribunal of First Instance in Brussels, the rule that excess dividends stemming cannot be carried over if they stem from subsidiaries in non-E.E.A. countries (with which Belgium does not have a bilateral tax treaty in force containing an equal treatment provision) does not run afoul of the Belgian constitutional non-discrimination rule. In the case at hand, the tax administration had allowed a taxpayer to carry over excess dividends from a Japanese subsidiary of a Belgian holding company – as there is an equal treatment provision in Article 23(2)(a) of the Belgian-Japanese bilateral tax treaty – but refused to allow the carry-over of Taiwanese and (South) Korean dividends, because in the treaties with Taiwan and Seoul do not equal treatment clause. Before the Brussels Tribunal, the taxpayer claimed that the aforementioned distinction ran afoul of the Belgian non-discrimination rule of Articles 10 *juncto* 172 of the Belgian Constitution. However, the Tribunal sided with the tax administration, arguing that the difference between an E.E.A.-source dividend and a "third country dividend" is based upon an objective criterion, hence permissible.

In a similar case, the Belgian Constitutional Court confirmed on October 10, 2012 that the denial of the carryforward of excess dividends received deduction for third countries not having a double tax treaty with an equal treatment clause for dividends, does not constitute a violation of the constitutional non-discrimination principle.

Minimum Participation Value

Dividends distributed by a subsidiary are eligible for the dividends received deduction if the corporate recipient owns at least 10% of the nominal share capital of the subsidiary or, alternatively, the acquisition price (value) for the holding in the subsidiary was at least €2.5 million.

Minimum Holding Period

A minimum holding period of one uninterrupted year is required in order for the dividends received deduction to apply. The minimum holding period of one uninterrupted year may occur partly before and partly after the dividend distribution. Moreover, the Belgian holding company is required to have full legal title to the shares. A so-called "right of *usufruct*" to the shares (a form of economic ownership to the dividends generated by the shares that exists for a limited period of time and is separate from the capital interest) does not suffice. Authoritative legal doctrine is of the view that the minimum holding period applies to the minimum (value of) participation-condition as described *sub* a above; in other words, dividends stemming from shares that were acquired less than one year before the distribution of the dividends, should qualify for the dividends received deduction provided the Belgian holding company had held on to 10% or €2.5 million worth of shares for one uninterrupted year immediately preceding (or partly before and partly after) the dividend distribution.

Subject to Comparable Tax

To qualify for the dividends received deduction, the subsidiary paying the dividend must meet a "subject-to-tax requirement." If the subject-to-tax requirement is not met, the dividends are not exempt in the hands of the corporate shareholder. Consequently, the dividends received deduction is not available for dividends distributed by a company that: (i) is neither subject to Belgian corporate income tax nor to a foreign tax similar to the Belgian corporate income tax, or (ii) is resident for tax purposes in a country that has in effect a normal tax regime which is substantially more advantageous than the Belgian normal tax regime. A foreign tax is not considered similar to Belgian corporate income tax if it is substantially more advantageous than that of Belgium (*i.e.*, below 15% nominal or effective rate). Pursuant the Royal Decree of February 13, 2003, the Belgian tax authorities published a list of jurisdictions that fail the "normal tax regime test" or the "not substantially more advantageous tax regime test." A Royal Decree dated January 27, 2010, updates this list.

Countries having tax regimes that are substantially more advantageous than the Belgian normal tax regime:		
Afghanistan	Guinee Bissau	Montserrat
Aldernay	Hati	Namibia
American Samoa	Herm	Niue
Belize	Iran	North Korea
Bosnia & Herzegovina	Iraq	Oman
British Virgin Islands	Isle of Man	Panama*
Burundi	Jersey	St. Christophe & St. Nevis
Cape Verde	Kribati	St. Pierre de Miquelon
Central African Republic	Laos	Samoa
Comores	Liberia	St. Lucia
Cook Islands	Liechtenstein	Saõ Tomé and Principe
Cuba	Macau	Seychelles
Dominica	Maldives	Somalia
Equatorial Guinea	Marshall Islands	Tinidad & Tobago
Gibraltar	Mayotte	Tuvalu
Grenada	Micronesia	U.S. Virgin Islands
Guernsey	Monaco	
*Prior to the Royal Decree of January 27, 2010, Panama was on this list, but the Belgian Ruling Commission had confirmed in a specific case that a Panamanian subsidiary of a Belgian corporation satisfied the subject to comparable tax test (Ruling No. 700.383 of November 13, 2007).		

The list is subject to periodical update and countries appearing on this list can still qualify for the subject-to-tax test if the taxpayer can prove that the participation is subject to a comparable tax.

The tax regimes of all E.U. jurisdictions, are deemed to be equivalent to the Belgian corporate income tax regime, even if the tax rate would be below 15% (*e.g.*, in Ireland).

Proscribed Business Activities

The dividends received deduction is not available for dividends distributed by a company defined as a finance company, a treasury company, or an investment company which, although in principle is subject to a tax regime that meets the standards set out above in the country where it is a resident for tax purposes, enjoys a tax regime that deviates from the normal tax regime.

A "finance company" is defined as a company the sole or principal activity of which consists in providing financial services (*e.g.*, financing and financial management) to unrelated parties (*i.e.*, parties that do not form part of a group to which the finance company belongs). "Group" is defined under a standard previously applicable to the Belgian Coordination Center Regime (*i.e.*, affiliated companies under a unique management due to direct or indirect participation(s); a "group" is presumed to exist when a company has 20% shareholding or voting rights in another company). As a result, a Belgian Coordination Center is not considered a finance company for this purpose.

"The dividends received deduction is not available for dividends distributed by a company defined as a finance company, a treasury company, or an investment company which... ...enjoys a tax regime that deviates from the normal tax regime."

A "treasury company" is defined as a company mainly or solely engaged in portfolio investment other than cash pooling.

An "investment company" is defined as a company the purpose of which is the collective investment of capital funds (*e.g.*, S.I.C.A.V.'s, S.I.C.A.F.'s, and comparable entities).

Under certain conditions, the dividends received deduction is nevertheless available for E.U.-based finance companies and for investment companies.

Offshore Activity

The dividends received deduction is not available for dividends distributed by a company to the extent that the non-dividend income the latter receives originates in a country other than the country where the distributing company is a resident for tax purposes and such income is subject in the latter country to a separate tax regime that deviates from the normal tax regime.

Certain Foreign Branch Income

The dividends received deduction is not available for dividends distributed by a company to the extent that it realizes profits through one or more foreign branches that are subject to a tax assessment regime substantially more advantageous than the tax regime to which such profits would have been subject in Belgium (*i.e.*, the Belgian corporate income tax regime for nonresident companies). Under certain conditions, the dividends received deduction is, however, available for dividends distributed by Belgian companies with foreign branches and also for dividends distributed by companies (established in certain treaty jurisdictions) availing of a foreign branch.

Dividends stemming from non-Belgian branch profits qualify for the dividends received deduction to the extent that either: (i) the branch profits are subject to a 15% corporate income tax or (ii) the company and its branch are located in another E.U. jurisdiction.

Intermediary Companies

The dividends received deduction is not available for dividends distributed by an intermediary company, other than an investment company, that redistributes dividend income derived from tainted participations. As a result, if at least 90% of a dividend received from an intermediary company is funded by its own receipt of dividends from subsidiaries located in third countries, the dividends received deduction may be disallowed if no deduction would have been permitted had the lower-tier companies paid dividends directly to the Belgian corporation. In other words, a group cannot "launder" tainted dividends by washing them through an intermediary located in an acceptable jurisdiction.

"The dividends received deduction may be disallowed if no deduction would have been permitted had the lower-tier companies paid dividends directly to the Belgian corporation."

As a safe harbor rule, participations in companies residing in a country with which Belgium has concluded a tax treaty and that are listed on a recognized E.U. stock exchange are always eligible for the participation exemption. These companies must be subject to a tax regime comparable to the Belgian tax regime, without benefiting from a regime that deviates from the normal tax regime.

With respect to investments in or through hybrid entities (*e.g.*, U.S. partnerships) the Belgian Ruling Committee issued several favorable rulings. In most instances, the Ruling Committee confirmed that for Belgian tax purposes one can look through the foreign hybrid entity and apply, *inter alia*, the participation exemption to the extent it would apply if the underlying participations had been held directly by the Belgian holding company.

Purchased Dividend

The term "purchased dividend" is used to describe the following fact pattern. At the time a target company ("Target") is being acquired by an acquiring company ("Acquirer") it has substantial earnings and profits on its balance sheet and the Acquirer pays "dollar for dollar" for such earnings and profits. Shortly after completion of the acquisition, the Acquirer has the Target to distribute substantially all of the pre-acquisition earnings and profits in the form of a dividend. In most instances, the Acquirer will subsequently utilize the proceeds of the dividend distribution to reimburse an equivalent portion of the acquisition debt.

Based on an Advice from the Belgian Commission for Accounting Standards ("C.A.S."), purchased dividends should not go through the Acquirer's profit and loss account, but should rather be utilized to reduce the book value (purchase price) of the Target-shareholding in the balance sheet of the Acquirer.[3] As a result, the purchased dividend is not included in the Acquirer's financial income; hence, it does not need to be deducted for 95% by virtue of the dividends received deduction. As a result, the Acquirer is not subject to tax on the nondeductible portion of 5% of the purchased dividend.

However, in a ruling of January 20, 2010 the Tribunal of First Instance of Bruges ruled otherwise and found that the purchased dividend had to be treated as taxable

[3] Advice No. 151/2 of March 1995.

(financial) income for the Acquirer. As a result, only 95% of that amount was tax deductible by virtue of the dividends received deduction, whereas 5% was effectively subject to tax in the hands of the Acquirer. The Acquirer appealed the ruling before the Court of Appeal of Ghent, but the latter court confirmed the ruling from Bruges (May 17, 2011). Commentators have criticized the rulings, arguing that the purchased dividend cannot be categorized as "income" for the Acquirer because the notion "income" requires that the beneficiary of the income is enriched, which is not the case with a purchased dividend.

Other Aspects

Interest and other expenses relating to the acquisition and/or the management of shares in, or capital contributions to, either a Belgian or a foreign subsidiary company remain in principle fully deductible to the extent that they meet regular arm's-length criteria. There is no general minimum debt-to-equity ratio. Finally, the participation exemption applies to payments received in connection with a liquidation or redemption of shares.

Pursuant to the law of June 23, 2005 and effective January 1, 2006, Belgian corporations are entitled to a notional interest deduction ("N.I.D."). The N.I.D. is a tax deduction for fictitious interest owed on the corporation's equity as it appears in its commercial balance sheet. The notional interest rate is restated every year. For 2012, the N.I.D., rate was capped at 3.00% (3.5% for S.M.E.'s). For fiscal year 2013, the rule regarding the method of computation of the N.I.D. rate was changed,[4] resulting in an N.I.D. rate of 2.74% (3.24% for S.M.E.'s).

For fiscal year 2016, the N.I.D. rate is equal to 1.63% (2.13% for S.M.E.'s).

As an austerity measure, unused portions of the N.I.D. can no longer be carried over to subsequent tax years.[5] To curb perceived abuses, the amount of equity that serves as the basis for computation of the N.I.D. is adjusted by deducting, *inter alia*, the commercial book value of participations that qualify for the participation exemption.[6]

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[4] Note that the Belgian government intends to limit the N.I.D. for banks and insurance companies by excluding part of the increase of the prudential capital under Basel III (banks) and Solvency II (insurance companies) from the deduction.

[5] Law of December 13, 2012 on Tax and Financial Provisions (Belgian State Gazette December 20, 2012, 4th Edition). Transitional provisions are available regarding the right to utilize any existing "inventory" of carried over N.I.D. going forward.

[6] The initial rule that excluded from the basis for computation of the N.I.D. the net assets of a Belgian corporation held through a branch ("permanent establishment") located in a treaty country and real estate located in a treaty country was repealed following the *Argenta Spaarbank* case of the E.C.J. (Case No. C-350/11 of July 4, 2013). The Belgian statute was amended on December 21, 2013, and the Belgian tax authorities commented on the new rules in a Circular Letter dated May 16, 2014. Note that the Belgian tax authorities and the Belgian courts have a different opinion regarding the application of the new rules. Indeed, the tax authorities have applied the amended N.I.D. calculation method for the past. The courts do not agree with that approach and state that the new rules only apply as of tax assessment year 2014 onwards.

The law of April 27, 2007 introduced a new tax deduction for patent income, amounting to 80% of the gross income deriving from the patent, thereby resulting in effective taxation of the income at the rate of 6.8% (rounded). This tax incentive is aimed at encouraging Belgian companies and permanent establishments to play an active role in patent research and development, patent ownership and manufacturing of products based on those patents. The tax deduction applies to new[7] patent income.

Ruling Practice

The Belgian tax administration must, upon the taxpayer's request, issue an advance tax ruling on *e.g.*, the availability of the dividends received deduction and especially on the question whether one or more anti-abuse provisions apply in a particular case. No such ruling will be granted, however, with respect to jurisdictions or types of companies listed as non-qualifying in the official tax haven list (see **Subject to Comparable Tax**, above). In principle, the tax authorities must issue their ruling within three months of the receipt of a complete and exhaustive ruling application.

Capital Gains Exemption

Under the participation exemption, net capital gains realized by a Belgian resident company (or the Belgian branch of a foreign company) on shares in a Belgian or a foreign subsidiary are either: (i) taxed at a special rate of 0.412% or (ii) fully exempt from Belgian corporate income tax (if the recipient is a corporation qualifying as an S.M.E.), provided the dividends on the shares qualify for the tests relating to the dividends received deduction (described above under the sections **Minimum Holding Period** through **Intermediary Companies**). However, if a foreign subsidiary derives dividends (directly or indirectly) from one or more companies not meeting the anti-abuse requirements for the dividends received deduction, the official view of the Belgian tax authorities is that the entire capital gain on the disposition of the shares of the subsidiary would be taxable.[8] Only the net amount of eligible capital gains is exempt from tax, in other words, costs and expenses incurred by the corporate shareholder in connection with the realization of the shares of stock must be deducted from the exempt amount of capital gains. Hence, such costs and expenses cannot be deducted from ordinarily taxed income to reduce additional corporate income tax.

No Minimum Ownership; One Year Holding Period Requirement

The minimum participation requirement that exists for dividends (10% of the capital or acquisition value of not less than €2.5 million) does not apply for capital gains. However, the same one year holding period requirement that exists for the dividends received deduction (see **Minimum Holding Period** in this chapter, above), now applies for the exemption of capital gains on shares (effective November 28, 2011) pursuant to the Program Law of March 29, 2012. The exemption applies only to the extent that the capital gain realized on the shares exceeds the tax book value of these shares.

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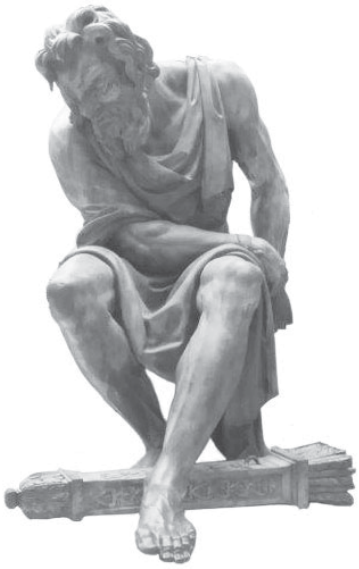
[7] In order to be considered as new, the income, in relation to patents, must not have been used by the company, a licensee, or a related enterprise for the purpose of the supply of goods or services to third parties prior to January 1, 2007.

[8] This is contested.

For many years, uncertainty existed as to the question of whether or not capital gains on shares could qualify for the participation exemption in a situation where the shares were acquired by the Belgian holding company at a price or value far below the actual (*i.e.*, fair market) value of the shares at the time of acquisition. For many years, the position of the Belgian tax authorities was that the difference between the (low) acquisition value or price and the (high) actual value of the shares must be earmarked as an "underestimation of assets" and taxed as regular income of the holding company at the full corporate tax rate (*i.e.*, 33.99%) in the year of acquisition of the shares.



This position was successfully challenged in the *Gimle* case, which required a preliminary ruling from the E.C.J. and has now been settled definitively by the Court of Cassation.[9] Going forward, capital gains derived from the disposal of shares that have been acquired by a Belgian holding company at a value or price far below their actual value, should benefit from the participation exemption regime.

The capital gain exemption is granted by a direct elimination of the net gains from taxable income. Consequently, the limitation connected with the method used for granting the dividends received deduction does not come into play and loss utilization is not adversely affected. This means that losses derived from other activities of the Belgian holding company do not absorb the participation exemption on capital gains.

Effective in tax assessment year 2014 (fiscal years ended on or after December 31, 2013[10]), if the recipient corporate taxpayer does not qualify as an S.M.E. (see **Participation Exemption - General**), the capital gains – computed in accordance with the same rules – are no longer fully exempt from corporation tax but are instead subject to separate taxation at the rate of 0.412%, regardless of the availability of N.O.L.'s or other tax attributes or tax assets.[11] The rate of 0.4% is increased by the austerity tax of 3%, bringing the aggregate effective rate to 0.412% of the capital gain.

As of 2013, capital gains on shares that fail the one-year holding test are taxed at a special rate of 25% (25.75% including the austerity tax of 3%).

The one-year holding requirement does not apply to qualifying financial institutions in connection with shares pertaining to their trading portfolio. Capital gains on such shares continue to be 100% exempt from corporate income tax, even if the one-year holding requirement is not met. Transfers from the trading portfolio to the financial assets will normally qualify for the full exemption for capital gains (even if the one-year holding requirement is not satisfied); conversely, transfers from the financial assets to the trading portfolio will be subject to: (i) the 25.75% capital gains tax if the one-year holding requirement is not satisfied, and (ii) the 0.412% tax if the one-year holding requirement is satisfied but the taxpayer does not qualify as an S.M.E.

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9 Court of Cassation, May 16, 2014, F.10.0092.F.

10 Amendments to the closing date of the fiscal year made on or after November 21, 2012 will have no effect on the applicability of the 0.412% tax on capital gains.

11 Program Law of December 27, 2012 (Belgian State Gazette, December 31, 2012).

Options

If a Belgian company purchases stock below fair market value pursuant to the exercise of a call option or a warrant, any subsequent gain realized upon the disposition of the shares of stock qualifies, in principle, as a tax-exempt capital gain. The exemption does not apply to the sale of the option or the warrant. If the call option itself were sold at a gain, the gain would not be eligible for exemption.

Unrealized Gains

Unrealized capital gains are not taxable if the capital gain is not expressed in the accounts. If the capital gain would merely be expressed in the Belgian company's accounts, said gain is not taxable so long as it is booked in a non-distributable reserve account. Upon later realization of such capital gain, the non-distributable reserve account disappears without triggering corporate income tax.

"Pursuant to the Law of June 22, 2005, only the net amount of capital gain is exempt, i.e., the gross capital gain minus costs and expenses incurred in connection with the realization of the gain..."

Capital Losses

As a counterpart to the exemption of capital gains, capital losses on the disposition of shares are not tax deductible. However, the loss incurred in connection with the liquidation of a subsidiary company remains deductible up to the amount of the paid-up share capital of that subsidiary. Corporate taxpayers are also not allowed to deduct any capital losses on the disposition of shares that are subject to the 0.412% tax on capital gains (see **No Minimum Ownership; One Year Holding** in this chapter, above).

Deductible Expenses

Interest paid by a Belgian company is generally tax deductible provided the general arm's length criteria and specific debt-to-equity rules are complied with. However, there are a few exceptions.

Pursuant to the Law of June 22, 2005, only the net amount of capital gain is exempt, *i.e.*, the gross capital gain minus costs and expenses incurred in connection with the realization of the gain (*e.g.*, brokerage fees, stamp duties, etc.). In a circular letter of April 6, 2006, the Belgian tax authorities commented on the limitation of the exempt amount of the capital gains on shares. This circular letter contains, *inter alia*, a list of costs and expenses that must be deducted from the gross amount of the sales proceeds of the shares in order to compute the net amount of the capital gain that is eligible for exemption from corporate income tax. Among others, the following costs and expenses must be deducted from the gross sales proceeds of a participation:

- Costs of publicity (*e.g.*, advertisements, etc.);
- Fees of a civil law notary;
- Brokerage fees;
- Financial costs (*i.e.*, foreign exchange losses);
- Financial discounts;
- Stamp taxes;

- Export levies;
- Insurance or other coverage costs;
- Commission fees;
- Advisory fees;
- Consultancy costs;
- Transportation costs;
- Technical audit and inspection costs (may include costs for vendor due diligence);
- Fees of experts, appraisers, etc.

The rationale behind this rule is to curtail the use of a "double dip" that existed until the Law of June 22, 2005 entered into effect in tax assessment year 2007 (*i.e.*, fiscal years beginning on or after January 1, 2006). On the one hand the gross amount of the sales proceeds of the shares was used to determine the exempt capital gain on shares, and on the other hand, all costs and expenses incurred with the sale of the shares were deductible from other ordinarily taxable income of the parent company.

Pursuant to the Law of March 29, 2012 (Article 147), the previously existing thin capitalization rule (Article 198, 11º, I.T.C.) was severely amended. The previously existing 7:1 debt-to-equity ratio was replaced by a 5:1 ratio, and in addition to interest beneficially owed to low-tax and tax haven lenders, all interest beneficially owed to companies of the same group is now subject to the thin capitalization rule. Because the government did not want this new thin capitalization rule to apply immediately to Belgium-based treasury centers of (predominantly U.S.-headquartered) multinational groups of companies, qualifying treasury centers are allowed to offset (or net) interest owed to group companies against interest received from group companies, and only the excess amount of net interest owed to group companies, if any, will be subject to the 5:1 thin capitalization rule.

WITHHOLDING TAX ON DISTRIBUTIONS

To Belgium

Dividends distributed to a Belgian company are, in principle, subject to a dividend withholding tax at the domestic rate of the country in which the distributing company is established. In most situations, this rate is reduced or eliminated by virtue of a bilateral tax treaty or the E.U. Parent-Subsidiary Directive. With the exception of investment companies, Belgium does not grant a tax credit for foreign withholding tax imposed on dividends.

From Belgium

In principle, all dividends distributed by Belgian companies to both resident and nonresident shareholders are subject to a withholding tax of 25%. Under very specific circumstances, a reduced rate of 15% is available.

A full exemption of Belgian withholding tax applies on the distribution of dividends to a parent company established (i) within the E.U. (including Belgian companies) or (ii) in a country with which Belgium has concluded a bilateral tax treaty containing an exchange of information provision, which holds at least 10% of the capital of the Belgian resident distributing company.[12] If a qualifying parent company holds or has held a qualifying participation, all additional acquired shares will also qualify, even though the one-year holding period may not be met with respect to such additional shares.

"A full exemption of Belgian withholding tax applies on the distribution of dividends to a parent company established (i) within the E.U.... or (ii) in a country with...a bilateral tax treaty."

***Denkavit* Case**

Following the ruling from the E.C.J. in the *Denkavit* case, Belgium abandoned the condition that the parent must have held a participation of at least 10% uninterruptedly during a period of at least one year preceding the distribution of the dividend. Therefore, the parent may hold the 10% participation for one entire year, which may occur partly before and partly after the dividend distribution. If the one-year period has not entirely elapsed at the time the dividend is paid, the Belgian distributing company is allowed to pay out the net dividend only (*i.e.*, the gross dividend minus an amount equal to the dividend withholding tax that would apply if the one-year holding period is not respected). If the latter occurs, the amount of withholding tax that becomes due, increased by interest for late payment, must be paid to the Belgian treasury by the dividend distributing company. Otherwise, the non-distributed portion of the dividend can be distributed freely once the one-year holding period has lapsed.

Unlike the participation exemption, the exemption from dividend withholding tax is subject to the conditions mentioned in the E.U. Parent-Subsidiary Directive with respect to the legal form, the E.U. tax residency, and the parent company's compliance with a subject-to-tax requirement. As a result of the amendment of the E.U. Parent-Subsidiary Directive, several types of entities that were not eligible for the withholding tax exemption are now included in the list, most notably the European Company or *Societas Europaea* ("S.E."). The legal form requirement does not apply to dividends paid to Belgian entities that are subject to Belgian corporate income tax.

Liquidation/Redemption Distributions

Until recently, the dividend withholding tax rate was 10% in the case of a liquidation of a Belgian company. This reduced rate has been abandoned effective October 1, 2014. A transitional regime encouraged companies to strengthen their capital by converting their reserves into capital before or during the accounting year ending at the latest on September 30, 2014 at a rate of 10%.

By doing so, the withholding tax of 25% upon liquidation could be limited to the 10% withholding tax due upon conversion.

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[12] The Belgian tax authorities take the view that the agreement between Belgium and Taiwan does not qualify as a bilateral tax treaty, hence the reduction of dividend withholding tax to 0% for dividends distributed by a Belgian company will not be available to the extent such dividend is distributed to a Taiwanese parent company.

The transitional 10% withholding tax regime for liquidation distributions has become permanent for S.M.E.'s. As of tax year 2015, S.M.E.'s are allowed to allocate part or all of their accounting profit to a liquidation reserve. This reserve needs to be booked on an unavailable equity account and will be subject to a separate 10% tax. No additional withholding tax will be due provided that this reserve is maintained until liquidation and hence distributed as a liquidation distribution.

Distributions to shareholders made pursuant to a resolution by the company to redeem or buy back its own stock from shareholders have been subject to a preferential withholding tax regime for many years (first at 0%, then at 10%), but that preferential regime was abandoned in 2012, effective January 1, 2013.

Distributions pursuant to liquidations and redemptions may be eligible for rate reductions or exemptions from withholding tax on the basis of the bilateral tax treaties concluded by Belgium, the E.U. Parent-Subsidiary Directive, or the unilateral extension of the E.U. Parent-Subsidiary withholding tax exemption discussed above.

Refund of Withholding Tax for Nonresident Investment Funds

Following the E.C.J. ruling of October 25, 2012 (Case No. C-378/11), the Belgian tax authorities issued a circular letter[13] regarding the conditions and formalities for nonresident investment funds to obtain a refund of Belgian (dividend or interest) withholding tax, in instances where a Belgian resident investment fund would be allowed to credit any Belgian withholding tax and obtain a refund to the extent the Belgian fund is not subject to corporate income tax on its investment income. As far as past dividends are concerned, the circular letter limits requests for refunds to dividends paid or awarded between January 1, 2007 and December 31, 2012 to investments funds covered by E.U. Directive 85/611/EEC of December 20, 1985, the provisions of which are now incorporated into Directive 2009/65/EC and transposed into Belgian law by virtue of the Law of August 3, 2012. Only the amount of withholding tax that cannot effectively be credited or reimbursed to the investment fund in its state of residence is eligible for a refund in Belgium.

Foreign investment funds may avail themselves to a five-year or ten-year period to claim the refund, depending on when the Belgian withholding tax was initially paid (on or after January 1, 2011, the period is five years following the date of payment of the withholding tax; prior to January 1, 2011 the period is ten years following the date of payment of the withholding tax). The circular letter does not mention whether or not interest for late payment will be allowed, but authoritative legal doctrine and case law from the Constitutional Court support the view that the refund of withholding tax is eligible for interest payment.

"Belgian companies making profit distributions must take into account a whole new tax, called the Fairness Tax."

Fairness Tax

Effective in tax assessment year 2014 (book years ending on or after December 31, 2013), Belgian companies making profit distributions must take into account a whole new tax, called the Fairness Tax.[14] Belgian companies (and Belgian branches of foreign companies) making profit distributions (*i.e.*, dividends) out of income that has not, effectively, been subject to corporate income tax may under certain conditions be subject to a standalone tax of 5.15% (5% + an austerity surcharge of

[13] Ci.R.H. 233/623.711, AAFisc No. 11/2013, dated March 4, 2013.

[14] Inserted in the Tax Code through the Law of July 30, 2013.

3%). Although the Fairness Tax is not a withholding tax but a tax on the distributing company (in many respects akin to the Alternative Minimum Tax laid down in I.R.C. §55 in the U.S.), it is a tax that should be looked after by companies making profit distributions out of insufficiently taxed earnings or profits. S.M.E.'s are exempt from the Fairness Tax. The Fairness Tax is imposed when the lack of corporate income tax on the distributed earnings and profits results from the application of the Notional Interest Deduction, (as mentioned earlier, the "N.I.D."), or carried over losses.

Since the introduction of the Fairness Tax, its application, legal validity and compliance with E.U. law have been questioned. It was, therefore, no surprise that a request to annul the Fairness Tax was filed with the Belgian Constitutional Court.[15]

In addition, rumors have spread that the European Commission claimed the Fairness Tax to be incompatible with the E.U. Parent-Subsidiary Directive, the freedom of establishment, and the freedom of capital. It is reported that the European Commission has unofficially informed Belgium that it has no fundamental objections against the Fairness Tax. The Belgian Constitutional Court has requested a preliminary ruling from the E.C.J. on the compatibility of the Fairness Tax with E.U. law.

As a result, the application of the Fairness Tax will remain subject to uncertainty until a preliminary ruling is delivered by the E.C.J. In practice, the E.C.J. often follows the judgment of the European Commission.

WITHHOLDING TAX ON OUTBOUND INTEREST PAYMENTS

Interest paid by any Belgian company is, in principle, subject to interest withholding tax of 25%. This domestic rate can often be reduced by virtue of bilateral tax treaties and several domestic exemptions, as well as the E.U. Interest and Royalty Directive as implemented in Belgium.

CAPITAL DUTY

Pursuant to the Law of June 23, 2005, the rate of the capital tax is set at 0%[16] for all contributions to share capital occurring on or after January 1, 2006.

V.A.T.

On the basis of E.C.J. case law, a distinction is made between so-called "active" and "passive" holding companies.[17] A passive holding company has no economic activity that gives entitlement to credit input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or participations. An active holding company, however, is involved in its subsidiaries' management. To the extent that its activities are neither exempt nor outside the scope of V.A.T., an active holding company can credit input-V.A.T. against output-V.A.T.

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[15] Constitutional Court case No. 11/2015 dated 28 January 2015 (No. 5828).

[16] Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

[17] A.o., C-77/01, April 24, 2004, EDM.

Based on a response in 2010 from the Belgian Minister of Finance on a Parliamentary Question,[18] even V.A.T. incurred in connection with the sale of shares may, under appropriate circumstances, be creditable and refundable. This insight is derived from the E.C.J.'s ruling of October 29, 2009, Case Nr. C-29/08 *Skatteverket v. AB SKF*. First, one should determine whether or not there is in principle a direct relationship between a "previous" transaction (*e.g.*, an input transaction on which input-V.A.T. is chargeable) and a "subsequent" transaction (*e.g.*, an output transaction that is subject to output-V.A.T.). If that is the case, the input-V.A.T. can be credited. Conversely, if there is a direct relationship between an input transaction and an output transaction that is either exempt from V.A.T. or outside the scope of V.A.T., the input-V.A.T. is not creditable (as was the situation in E.C.J. Case No. C-4/94 of April 6, 1995 *BLP Group*). However, if no direct relationship exists between the input transaction and any output transaction, the input-V.A.T. may still be creditable, provided that the cost for the input services, on which input-V.A.T. was due, is part of the general expenses of the taxpayer and is included in the price charged by the taxpayer for goods delivered or services rendered.

"Private P.R.I.C.A.F.'s are private."

"[It] is not a holding company per se and is not allowed to acquire the control of a company."

This principle was formulated in the *Skatteverket v. SKF* E.C.J. case of 2009 – where the Belgian tax administration accepted that input-V.A.T. could be creditable in the event of an issuance of new shares or the purchase of shares. Until recently, they follow the same reasoning for V.A.T. incurred in connection with the sale of shares. However, according to the Minister of Finance, no V.A.T. credit is available if the cost of the input transaction on which V.A.T. was charged is included into the sales price of the shares, which is either exempt or out of the scope. Only in the event that the cost of the input transaction is included in the price of output transactions subject to V.A.T. (*i.e.*, neither exempt, nor out of the scope) will the input-V.A.T. be credited and recovered.

PRIVATE P.R.I.C.A.F.

Private P.R.I.C.A.F.'s are private (*i.e.*, non-listed), collective investment undertakings, aimed at investing in non-listed companies. In principle, a private P.R.I.C.A.F. is not a holding company *per se* and is not allowed to acquire the control of a company (minor derogations are allowed).

A Private P.R.I.C.A.F. can take the form of a company limited by shares or a limited partnership with a share capital. It is a closed-end fund, established for a period not exceeding 12 years for "private investors" (*i.e.*, persons investing at least €50,000). The Private P.R.I.C.A.F. must have at least six "private investors."

The Private P.R.I.C.A.F. may invest in a broad range of financial instruments issued by non-listed companies: shares, bonds and other debt instruments, securities issued by other undertakings for collective investment, derivative financial instruments (subscription rights, options, etc.) and loans (*e.g.*, the Private P.R.I.C.A.F. may serve for mezzanine financing). Other investments are either partially and/or temporarily authorized or prohibited.

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[18] Parl. Question, No. 299 of January 12, 2010 (Brotcorne), Q&A, Chamber 2009-2010, No.52-102, 107.

The Private P.R.I.C.A.F. is subject to corporate income tax, but its taxable basis deviates from the normal corporate income tax regime and is limited to certain elements (non-arm's length benefits received, nondeductible expenses including payments in lieu of dividends under stock-lending transactions), such that in principle, the Private P.R.I.C.A.F. does not pay income taxes.

Dividends distributed by a Private P.R.I.C.A.F. are in principle liable to a 25% withholding tax. However, distributions stemming from capital gains realized on shares by the Private P.R.I.C.A.F. are exempt from withholding tax, as well as redemption premiums or liquidation gains. Under conditions, the dividends distributed by the Private P.R.I.C.A.F. may benefit from the dividends received deduction regime.

B.E.P.S. IN BELGIUM

In General

Belgium has not yet implemented any measures that are a direct reaction to the 15 B.E.P.S. action items. This may reflect a view that because not all of the B.E.P.S. recommendations are final yet, the government prefers to see the final product before adopting legislation. In addition, in some areas such as controlled foreign corporations ("C.F.C.'s") (Action 3) and excessive interest deductions (Action 4), Belgium already has rules that are very similar to the O.E.CD. anti-B.E.P.S. proposals. Of course, amendments and extensions are always possible to increase conformity between domestic law and the O.E.C.D. actions. In areas such as hybrid mismatches (Action 2) – albeit via E.U. legislation – and transfer pricing (Actions 8-10 and 13), Belgium has started the implementation of rules that are in line with the B.E.P.S. Action Plan. In other areas such as e-commerce (Action 1), permanent establishment rules (Action 7) and tax abuse (Actions 5, 6 and 12), there is certainly room for progress. The Minister of Finance announced that the Belgian government is supportive of the B.E.P.S. project and will take legislative action as to follow the B.E.P.S. recommendations. However, Belgium prefers coordinated rather than unilateral action, and will take (further) legislative action only when the outcome of the B.E.P.S. project is clear.

Measures Implemented in Line with B.E.P.S.

B.E.P.S. Action 2: Hybrid Mismatches

Recently, the E.U. decided to amend the Parent-Subsidiary Directive in order to tackle hybrid instruments triggering double non-taxation. An example of a hybrid instrument often used in Belgium and Luxembourg is the so-called Profit Participating Loan (or "P.P.L."). Whereas Belgium treats the P.P.L. as debt allowing the Belgian debtor a deduction of paid interest, Luxembourg treats the P.P.L. as equity exempting the received income from tax (provided the Luxembourg recipient meets the test to qualify as a "parent" of the Belgian payor).

According to the revised E.U. Parent-Subsidiary Directive, a Member State of a parent company must refrain from taxing profits distributed by qualifying subsidiaries of another Member State only to the extent that the distributions are not tax deductible in the Member State of the subsidiary. If the profit distributions are tax deductible in

the Member State of the subsidiary, then they must be taxed by the Member State of the parent company.

As an E.U. Member State, Belgium must implement the new anti-hybrid rule within its domestic legislation by December 31, 2015. This amendment must be seen in light of the O.E.C.D. efforts to close any loopholes in the international tax system that enable base erosion and profit shifting. While the European Commission acknowledges the contributions of O.E.C.D.'s B.E.P.S. initiative, it states that there also is a need to address mismatches and anti-abuse at the E.U. level, and that the revision of the Parent-Subsidiary Directive can be an important contribution to the O.E.C.D.'s work. The Belgian Minister of Finance also emphasized the need to coordinate the O.E.C.D.'s B.E.P.S. initiative with related E.U. actions.

B.E.P.S. Action 3: C.F.C. Rules

Belgium may not have C.F.C. legislation in place yet, but it does already have extensive anti-abuse rules that have a similar effect as C.F.C. rules. There is for example Article 344 §2 of the I.T.C., which tackles asset transfers to tax havens. Article 54 of the I.T.C. denies the deduction of interest payments to low-taxed entities and Article 307 of the I.T.C. imposes a reporting obligation to taxpayers making payments to offshore entities.

"As an E.U. Member State, Belgium must implement the new anti-hybrid rule within its domestic legislation by December 31, 2015."

Recently, the Belgian government approved draft legislation introducing the so-called "look-through tax" (or "Cayman tax") for income derived by individual taxpayers from the use of foreign vehicles such as trusts or foundations. These legal constructions already must be reported in the personal income tax return (as of tax year 2014), but the income from such constructions is often not taxable in Belgium. Taxation will be imposed by considering these legal constructions as tax transparent, so that the income would be taxable directly in the hands of the resident individual who is the shareholder or beneficiary of the construction.

B.E.P.S. Action 4: Excessive Interest Deductions

Similar to most other countries, Belgium already has various rules limiting excessive interest deductions. The most known rule is the thin capitalization rule (or "thin cap"). In 2012, the thin cap rules became more stringent. The scope was expanded so as to include interest payments to group companies (not only low-tax companies). The debt-to-equity ratio was set at 5:1 instead of 7:1. It is not clear whether, in light of the B.E.P.S. initiative, the Belgian thin cap rule should be tightened and expanded to apply to interest on all debt owed by a domestic corporation.

B.E.P.S. Actions 8, 9, 10 and 13: Transfer Pricing

In Belgium, developments in the transfer pricing area can be seen in the increase in tax audits and implementation of documentation rules in line with the B.E.P.S. project.

Belgium has transfer pricing rules in place to avoid profit shifting, and in recent years the number of transfer pricing audits has increased remarkably. However, Belgium does not have any specific statutory transfer pricing documentation requirements in place yet. It is of course advisable to have sufficient documentation available, as the lack of documentation may result in a thorough transfer pricing audit. Other than

that, the normal rules regarding the burden of proof will also apply in the transfer pricing area. In principle, the tax authorities carry the burden of proof when contesting a tax return that is filed on time and in compliance with all formal rules – but when the tax authorities have reasonable grounds to disagree with the taxpayer and impose a supplemental tax assessment, the burden of proof will shift to the taxpayer.

Recently, the Belgian Minister of Finance stated that, as part of the B.E.P.S. project, the Belgian government envisages introducing formal transfer pricing documentation requirements which would contribute to more transparency and more efficient tax audits. He also announced that the specialized transfer pricing investigation team will continue to conduct transfer pricing audits in Belgium. No new transfer pricing rules are currently being proposed.

SWEDEN

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IN GENERAL

Sweden has emerged as an attractive country for establishing financing and holding companies for both E.U. and non-E.U. corporations. However, intra-group interest restrictions may affect this status negatively. The key features of the Swedish holding company regime are:

- A very favorable participation exemption regime for both dividends and capital gains;
- No thin capitalization rules;
- No withholding taxes on outbound interest payments;
- An extensive network of double tax treaties (more than 80 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains;
- A low corporate income tax rate (*i.e.*, 22%) with indications to drop further;
- Relatively low requirements on minimum share capital – SEK 50,000 (approx. €6,000); and
- No withholding tax on dividend distributions to qualified U.S. shareholders (with a minimum holding of 80% of the votes and minimum holding period of 12 months) or 5% withholding tax for holdings amounting to 10% or more of the votes (with no holding period requirement).

The main legal entity used for holding and financing purposes is the Swedish limited liability company ("*Aktiebolag*" or "A.B."). The A.B. has both legal competence and the formal capacity to act as a party before authorities and courts, and it is a legal entity for Swedish tax purposes. An A.B. is also a qualifying entity under the Swedish participation exemption.

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In early June of 2014, a report was presented that proposed an overhaul of the Swedish corporate tax system. However, the proposals contained in this report were heavily criticized. As a result of such criticism and the change in government, which occurred later in the year, all proposed changes have now been postponed. The few developments that have taken place are, thus, a result of case law. A very brief summary of the report is, however, still included at the end of this article.

PARTICIPATION EXEMPTION

General

The net income of a Swedish company is normally subject to corporate income tax at a rate of 22%. However, if both the holding company and the subsidiary are qualifying entities under the participation exemption, income from capital gains and dividends are tax exempt. According to Chapter 24 of the Swedish Income Tax Act ("I.T.A."), the holding entity must be in one of the following forms in order to qualify:

- A Swedish A.B. or a Swedish economic association that is not an investment company;
- A Swedish foundation or a Swedish non-profit association that is not subject to tax exemption according to Chap. 7 I.T.A.;
- A Swedish savings bank;
- A Swedish mutual insurance company; or
- A "foreign company" resident within the E.E.A. that is the equivalent of any of the foregoing entities.

"Net income of a Swedish company is normally subject to corporate income tax at a rate of 22%."

The term "foreign company" is defined in the I.T.A. as a foreign legal entity that is subject to tax in its country of residence, if such taxation is similar to the taxation of a Swedish A.B. In general, a tax rate of 60% of the statutory Swedish rate is acceptable, *i.e.*, currently 14% (60% of 22%) or more. Also, a foreign legal entity resident in a country with which Sweden has signed a double tax treaty is always deemed a "foreign company" if the entity is entitled to the benefits of the treaty and the treaty is not limited to certain types of income.

The share held must be a share in an A.B., an economic association, or a similar foreign entity (see **Qualifying Foreign Entities** below). The share must also be a capital asset (*e.g.*, assets other than trading stock, inventory, work-in-progress, receivables and similar assets, equipment, patents, and other intangibles). Additionally, it must meet one or more of the following criteria:

- The share is not listed;
- The holding entity owns shares representing at least 10% of the total number of votes of the company; or
- The holding is deemed necessary for the business conducted by the owner or any other company within the community of interests of the owner.

If both the holding entity and the subsidiary fulfill the abovementioned conditions, the shares held are deemed "business-related shares" and thus qualify under the participation exemption.

Dividends

In general, dividends received from business-related shares are tax exempt. If the shares are listed, they must be held for a period of at least one year from the time when the shares became business-related for the holding entity. Also, dividends on shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

Capital Gains

Capital gains on the disposal of business-related shares are tax exempt. Accordingly, a capital loss derived from the disposal of those shares is not tax deductible. If the shares are listed, the capital gain is tax exempt provided that they have been deemed business-related shares, with regard to the seller, for at least one year immediately preceding the disposal.

Capital gains arising from the disposal of an interest in a Swedish partnership or a foreign tax-transparent entity resident within the E.E.A. are tax exempt if the interest is owned by a company qualified for holding business-related shares. Also, capital gains arising from shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

Qualifying Foreign Entities

Shares in foreign legal entities may also qualify as business-related shares if the legal entity corresponds to a Swedish limited liability company. The relevant provisions in the I.T.A. do not state what conditions should be met in order for a foreign legal entity to correspond to a Swedish A.B. In a case regarding a Russian limited liability company ("O.O.O."), the Supreme Administrative Court based its decision mainly on the resemblance, from a civil law perspective, between an O.O.O. and a Swedish limited liability company. In addition, the O.O.O. in question was subject to income tax in Russia. Therefore, it was deemed to correspond to a Swedish limited liability company. So far, a large number of foreign legal entities have been deemed to correspond to Swedish A.B.'s by the Supreme Administrative Court and the Board for Advance Tax Rulings.

"Sweden may not impose withholding tax on dividends if the U.S. holding... amounts to at least 80% of the votes... for at least one year."

WITHHOLDING TAX

Outbound Dividends

Under the Swedish Withholding Tax Act ("W.T.A."), a 30% withholding tax is levied upon the distribution of dividends by a Swedish A.B. However, due to the implementation of the E.U. Parent-Subsidiary Directive and Sweden's extensive network of double tax treaties, withholding tax will not be imposed or will be imposed at a reduced rate in most cases. Under the double tax treaty concluded between the U.S. and Sweden, for instance, Sweden may not impose withholding tax on dividends if the U.S. holding in the Swedish company amounts to at least 80% of the votes and has been in place for at least one year. If the size of the holding is below 80% but amounts to 10% or more of the votes, the withholding tax rate is instead reduced to 5% of the gross amount distributed.

Dividends distributed to a legal entity resident within the E.U. are exempt from withholding tax if the recipient holds at least 10% of the share capital in the distributing company and fulfills the conditions set forth in art. 2 of the E.U. Parent-Subsidiary Directive.

Also, if the shares in the distributing company are deemed business-related shares under the participation exemption regime and the dividend (or capital gain at disposal of the shares) would have been tax exempt if the entity holding the shares had been a Swedish company, the dividend is exempt from withholding tax.

Inbound Dividends

Withholding tax on distributions from foreign subsidiaries is often eliminated under the E.U. Parent-Subsidiary Directive or reduced under a double tax treaty.

Treaty Chart

Sweden currently has over 80 double tax treaties in effect, in addition to a vast number of tax information exchange agreements ("T.I.E.A.'s").

Double tax treaties are in effect with the following countries:		
Albania	Hong Kong	Portugal
Argentina	Iran	Romania
Australia	France	Russia
Austria	Gambia	Singapore
Bangladesh	Germany	Slovakia
Barbados	Iceland	South Africa
Belarus	Ireland	Spain
Belgium	Israel	Sri Lanka
Bermuda	Italy	Switzerland
British Virgin Islands	Jamaica	Taiwan
Bolivia	Japan	Tanzania
Botswana	Kazakhstan	Thailand
Brazil	Latvia	Trinidad & Tobago
Bulgaria	Lithuania	Tunisia
Canada	Mauritius	Turkey
Cayman Islands	Mexico	Ukraine
Chile	Namibia	United Kingdom
China	Netherlands	United States
Cyprus	New Zealand	Uruguay
Czech Republic	Norway	Venezuela
Denmark	Oman	Vietnam
Egypt	Peru	Yugoslavia (former)
Estonia	Philippines	Zambia
Faeroe Islands	Poland	Zimbabwe
Finland		

FINANCING

Loan Financing

As a general rule, all interest payments are deductible without limitation. Sweden does not impose withholding tax on interest payments. As there are no thin-capitalization rules (*i.e.*, interest deductibility is not dependent on the fact that a certain debt-to-equity ratio is upheld), highly leveraged structures can be used.

From a transfer pricing perspective, the interest rates charged must be at arm's length. Interest rates charged between related parties that deviate from market conditions may be challenged by the Swedish Tax Agency ("S.T.A.").

Limitations exist on deductions for interest expense attributable to loans from affiliated companies. Interest charged to the Swedish company will qualify for tax deduction only in cases where debt financing is in place for commercial reasons. This new regulation is a reaction to the seemingly widespread practice for Swedish tax structures to reduce Swedish corporate taxation using intercompany loans from low tax jurisdictions.

Equity Contributions

Under Swedish law, there are two types of shareholders' contributions available: conditional and unconditional contributions. An unconditional contribution is a final investment in the company, without a claim for future repayment. An unconditional contribution is not deemed to be taxable income for the company. However, it is indirectly a deductible expense for the contributor, since the contribution is added to the tax basis of the shares and is thus deductible when calculating future capital gain or loss – if the investment is a taxable investment – on the disposal of the shares.

A conditional contribution is deemed to be a loan for tax purposes. Repayment of a conditional contribution is not regulated in Swedish tax law, but according to case law, a repayment is generally treated as the repayment of a loan and, thus, is not a taxable event, unless special circumstances are at hand.

Sweden does not impose any transfer tax or stamp duty on equity contributions.

LIQUIDATION

Distributions

Under the I.T.A., the liquidation of a company is deemed a taxable disposal of the shares issued by the liquidated company. Thus, an individual shareholder is normally taxed on the difference between the amount distributed during the liquidation and his/her tax basis in the shares. If the shares are business-related shares, no capital gain or loss will be recognized. For foreign shareholders, a distribution in connection with the liquidation of a company is deemed to be a distribution of a dividend. Thus, withholding tax will be levied on the distributed (gross) amount unless treaty rules provide otherwise. If the company is dissolved within two years of the distribution, the shareholder's acquisition value for the shares may be deducted. The taxpayer will receive a reimbursement for the amount of withholding tax paid that exceeds the amount of tax imposed on the difference between the distributed amount and the acquisition value. However, as previously mentioned, withholding tax will in most cases be eliminated or imposed at a reduced rate.

Losses

Final losses on the liquidation of foreign subsidiaries give rise to a special group deduction ("*koncernavdrag*"). The deduction results from Sweden becoming an E.U. Member State. However, it applies in very restricted circumstances, as illustrated by the following conditions that must be met in order for a group deduction to be allowed:

- The foreign subsidiary must be located within the E.U.;
- The foreign subsidiary has been liquidated;
- Until the liquidation is completed, the foreign subsidiary has been wholly-owned either during the entire fiscal year of both the parent and the subsidiary or since it started conducting business of any kind;
- The deduction of the group contribution is made in connection with the tax assessment of the fiscal year during which the liquidation is completed;
- The deduction of the group contribution is openly disclosed in the tax assessment of the parent company; and
- None of the companies within the parent company's community of interests conduct business in the domicile state of the subsidiary after the completion of the liquidation.

"If a company acquires a controlling interest in a company with N.O.L.'s... restrictions apply regarding the use of those N.O.L.'s."

A loss is considered final only if the subsidiary, or another person in the domicile state of the subsidiary, has utilized the loss and will not be able to utilize it in the future. If the loss is not utilized because the law of the domicile state does not provide for such a possibility or that such a possibility is limited in time, the loss will not be considered final.

There are also limitations as to the amount that may be deducted. The deduction may not exceed the loss of the foreign subsidiary at the end of the last complete fiscal year before the end of the liquidation or before the liquidation. The deduction may not exceed the positive result of the parent company before the deduction. When calculating the result of the parent company, any group contribution received from the subsidiary after it became wholly-owned is disregarded if such a contribution has caused or increased the loss in the subsidiary.

NET OPERATING LOSSES

The taxable result of a business is calculated as the difference between gross taxable income and allowed deductions. Net operating losses ("N.O.L.'s") can be utilized by means of a carryforward. Excess N.O.L.'s are forwarded to the next fiscal year and used as a deduction when calculating the taxable result of the business. N.O.L.'s from previous years may be carried forward indefinitely.

If a company acquires a controlling interest in a company with N.O.L.'s from previous years, certain restrictions apply regarding the use of those N.O.L.'s. First, the N.O.L. deduction is capped at 200% of the acquisition price. Second, the Swedish practice of moving losses within a group through contributions that are deductible for the payor and income for the recipient are not allowed until the sixth year following the year in which the loss company was acquired. These restrictions do not apply to group internal restructurings.

TRANSFER PRICING

Sweden applies a transfer pricing provision based on the O.E.C.D. arm's length principle. In practice, this means that prices charged between related parties must be set in accordance with market rates. If internal pricing deviates from the rates charged by independent parties and the taxable result of the Swedish company is therefore reduced, the S.T.A. may challenge the taxable result. Additionally, Swedish companies are required to keep documentation on cross-border transactions with related parties.

In order to avoid future transfer pricing conflicts with the S.T.A., it is possible to apply for a binding Advance Pricing Agreement ("A.P.A."). The fee for obtaining an A.P.A. is currently SEK 150,000 (approx. €19,000). The agreement is normally valid for three to five taxable years.

As is the case in other countries, the S.T.A. has increased its focus on transfer pricing matters in recent years. It is likely that the above-mentioned rules will be modified as a result of the so-called "B.E.P.S. Project" administered by the O.E.C.D. Furthermore, the S.T.A. will likely enhance its focus on intercompany transactions and requirements for documentation and information from the taxpayer. Additional comments on B.E.P.S. will be made separately, later in this article.

CONTROLLED FOREIGN CORPORATION – C.F.C.

The purpose of the Swedish C.F.C. rules is to prevent Swedish persons or companies from deferring or avoiding taxation by collecting funds in a foreign subsidiary resident in a low tax jurisdiction. If a foreign subsidiary is deemed to be a C.F.C., a shareholder subject to tax in Sweden will be taxed directly for his/her share of the C.F.C.'s profit – as calculated under Swedish G.A.A.P. and tax rules, irrespective of whether any funds have been distributed. Any tax paid in the foreign jurisdiction is creditable against Swedish tax.

In order for the C.F.C. rules to be applicable, the foreign corporation must be subject to low tax, which is defined as a tax rate lower than 55% of the Swedish corporate tax rate (*i.e.*, 12.1%). The controller (*i.e.*, the person subject to C.F.C. taxation) must own or control at least 25% of the capital or votes of the foreign corporation alone or together with persons in a communal interest with the controller.

There are two exceptions from the C.F.C. rules:

- First, regardless of the level of taxation, a foreign legal entity is deemed not to be a C.F.C. if it is resident for tax purposes in a country mentioned on the so-called "white list." If Sweden has concluded a double tax treaty with such a country, the aforementioned exception from the C.F.C. rules is only applicable on income that falls within the scope of the treaty.
- Second, if the C.F.C. is resident for tax purposes within the E.E.A. and is deemed to be a "real establishment" from which a commercially motivated business is conducted, the C.F.C. rules are not applicable.

BASE EROSION AND PROFIT SHIFTING – B.E.P.S.

Sweden has slowly taken an increased interest in combatting B.E.P.S. and in the development of the B.E.P.S. Project at the level of the O.E.C.D. As of May 2015, the influence of the B.E.P.S. Project is mainly seen in the legal debates and, possibly, in the tax courts. No new Swedish regulations, recommendations, or case law developments have come, specifically, out of the B.E.P.S. Project, but it is assumed they are forthcoming. Consequently, the B.E.P.S. Project has had only an indirect effect. Nonetheless, the S.T.A. is learning from the analysis as well as the comments made by different parties. It is clear that most tax agencies in the Nordics have become more aggressive in their positions during tax audits. Long term, it is assumed that the B.E.P.S. Project will trigger an increased documentation and compliance burden for taxpayers. It is important to keep in mind that many of the B.E.P.S. Actions will not require a change of law (as effected ultimately by the Swedish parliament) but by a change of the O.E.C.D. Guidelines, which will be utilized as a point of reference for the S.T.A. and implemented by the tax courts. In this context, legislators in most countries have been driven by media attacks on tax planning methods of multinational groups and the likely effect is that more "double-taxation" will occur in order to prevent "double non-taxation."

PROPOSED NEW CORPORATE TAX RULES

In early June 2014, a report on the possible revision of the Swedish corporate tax system was introduced. In brief, the proposal entailed a drastic change in the statutory tax rate (which would be decreased to 16%) and the manner in which the tax base is calculated. One drastic – and heavily criticized – proposal was a limitation on the deductibility of financial expenses to financial income, but not ordinary operating income. To mitigate the effect of this proposal, a "financial expense deduction" was to be introduced. In the report, it was presented as 25% of the net result of the company. This was to apply regardless of the actual interest expense.

As an alternative, the report presented a reduction of the statutory tax rate by 3.5% (*i.e.*, from the current rate of 22% down to 18.5%) in combination with a "financial expense deduction" of 20% of the company's E.B.I.T.A.

For obvious reasons, the definition of what is included in "financial expenses" and "financial income" was not clear. At the time, the reference was made only to accounting rules. It was generally thought that some industries were to be significantly hurt, such as the real estate sector.

"Sweden has slowly taken an increased interest in combatting B.E.P.S. and in the development of the B.E.P.S. Project at the level of the O.E.C.D."

DENMARK

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IN GENERAL

For years, Denmark has been attractive to foreign investors for investment purposes for several commercial reasons, such as its:

- Highly developed infrastructure;
- High level of education combined with entitlement to terminate employment; and
- High ratio of coverage for I.T. and electronic equipment.

The investor-friendly environment is supported by a corporate tax regime primarily designed for operating entities, which generally allows for:

- A corporate income tax rate of 23.5%, which will be further decreased to 22% in 2016;
- Zero corporate tax on inbound dividends received by a Danish company with a participation of at least 10% in a subsidiary situated in the E.U. or a country which has a double taxation treaty with Denmark, or if the Danish company and the subsidiary are eligible for tax consolidation;
- Zero withholding tax on outbound dividends to E.U./E.E.A. and treaty-country resident corporate parents having a participation of at least 10% (subject to an anti-abuse rule discussed below); and
- Reduced tax on inbound and outbound dividends on portfolio shares (shareholdings of less than 10%) as a result of a strong network of tax treaties with 74 countries.

The Danish corporate tax regime also provides for:

- No capital duty on capital contributions;
- No stamp or transfer duty (save in the form of registration charges) with respect to fixed property, ships, and aircraft;
- No capital gains taxation on share profit at the level of the Danish company, provided that the Danish company owns at least 10% of the shares in the subsidiary, and no tax on capital gains from the disposition of non-listed portfolio shares (holdings of less than 10%) of a Danish private limited company or a similar foreign company;[1]
- No wealth tax on foreign investors within the holding period;

[1] See **Capital Gains Taxation** below.

- No exit tax on foreign investors (foreign investors are not subject to limited Danish tax liability on their disposal of shares in a Danish company); and
- A flexible corporation law regime with no red tape.

On the other hand, some Danish rules have proven to discourage or hamper investments, such as:

- Danish controlled financial company rules under which investments in foreign finance companies do not benefit from the Danish Holding Regime;
- Corporate law restrictions on up-streaming of cash flow to foreign investors through loans from a Danish holding company or through the provision of security for the indebtedness of a foreign investor;
- Tax legislation targeting debt-leveraged acquisitions of Danish companies, in particular international tax planning strategies involving U.S.-Danish check-the-box structures and offshore financing structures; and
- An anti-avoidance rule enacted as of 2013, which is intended to prevent the use of Denmark as an intermediary to reduce withholding tax in other countries. Denmark will no longer apply its internal exemption from withholding tax and will instead apply a higher treaty rate, if (i) the outbound dividend distributed by the Danish company stems from dividends received from lower tier foreign affiliates, (ii) the shareholder of the Danish company is not entitled to the E.U. Parent-Subsidiary Directive, and (iii) the Danish company is not the beneficial owner of the dividends it received (known as a "conduit situation").[2]

"A Danish company is subject to Danish income taxation at a flat rate of 23.5%....

The rate will be reduced to 22% in 2016."

CORPORATE INCOME TAX

A Danish company is subject to Danish income taxation at a flat rate of 23.5% (2015). The rate will be reduced to 22% in 2016. This rate applies whether or not profits are distributed.

A modified principle of worldwide income taxation applies. A Danish company is now generally taxed on the basis of a territorial principle in relation to profits from foreign real property and profits from a foreign permanent establishment ("P.E."). Similarly, losses from those items will not be deductible against taxable income in that Danish company. However, if an election has been made for cross-border tax consolidation,[3] profits and losses from foreign real property and from P.E. operations will be included in the Danish taxable income in accordance with the worldwide income principle. In addition, an anti-abuse rule provides that low-taxed financial income generated through a foreign branch is also included in the income of the Danish company.

Danish domestic tax law may be modified under a relevant double taxation treaty. No local income taxes are levied by cities or regions on companies or branches in Denmark.

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[2] For further discussion, see **Tightening of the Danish Rules for Exemption of Danish Dividend Withholding Tax** below.

[3] See **Group of Companies – Joint Cross-Border Taxation** below.

WITHHOLDING TAX ON A SUBSIDIARY FOREIGN

Dividends paid by a foreign subsidiary to a Danish holding company may be subject to withholding tax, which may be eliminated or reduced pursuant to the E.U. Parent-Subsidiary Directive or a tax treaty between Denmark and the country in which the foreign subsidiary is located.

Denmark has income tax treaties in effect with the following countries:		
Argentina	Indonesia	Portugal
Australia	Ireland	Romania
Austria	Israel	Russia
Bangladesh	Italy	Serbia
Belarus	Jamaica	Singapore
Belgium	Japan	Slovakia
Brazil	Kenya	South Africa
Bulgaria	Kuwait	Sri Lanka
Canada	Kyrgyzstan	South Korea
Chile	Latvia	Sweden
China	Lithuania	Switzerland
Croatia	Luxembourg	Taiwan
Cyprus	Macedonia	Tanzania
Czech Republic	Malaysia	Thailand
Egypt	Malta	Trinidad & Tobago
Estonia	Mexico	Tunisia
Faeroe Islands	Montenegro	Turkey
Finland	Morocco	Uganda
Georgia	Netherlands	Ukraine
Germany	New Zealand	United Kingdom
Greece	Norway	United States
Greenland	Pakistan	Venezuela
Hungary	Philippines	Vietnam
Iceland	Poland	Zambia
India		

Limited tax information exchange agreements ("T.I.E.A.'s") have been concluded with a number of other countries.

CORPORATE TAXATION OF INBOUND DIVIDENDS

Dividends received from a foreign subsidiary are generally exempt from Danish corporate income tax if the following conditions are met:

- The foreign subsidiary qualifies as a "company" under Danish law;
- Either (i) the Danish company holds at least 10% of the shares of the foreign subsidiary, and the foreign subsidiary is covered by the E.U. Parent-Subsidiary Directive or is resident in a state that has concluded a double taxation treaty with Denmark according to which the withholding taxation of the dividends is reduced or waived, or (ii) the Danish company and the foreign subsidiary qualify for international joint taxation (generally meaning that the Danish company must control more than 50% of the votes in the foreign subsidiary); and
- The dividend is not received from a non-E.U. entity, which has taken a tax deduction with respect to the dividend payment.

If the Danish company directly or indirectly holds less than 10% of the foreign subsidiary, the dividend payment will be subject to tax at the standard corporate income tax rate of 23.5% (22% in 2016 and onwards).

The qualification of a foreign subsidiary as a "company" is made by applying Danish law. No regard is given to the classification of the entity under foreign law. The issue is a question of fact and the criteria applied include whether, by the terms of local law or an entity's corporate charter: (i) the entity carries on business for profit, (ii) the entity has a fixed share capital, (iii) the entity provides limited liability for all its shareholders, and (iv) the claim on the profit of the entity is apportioned to the owners by reference to their respective share holdings. In addition, an entity that is formed under the laws of a member of the E.U. is treated as a corporation if it is subject to the Parent-Subsidiary Directive. If for some reason the directive is inapplicable, the entity will be characterized under the four-pronged standard that generally applies.

C.F.C. TAXATION

Danish tax law contains controlled financial company ("C.F.C.") provisions, which apply to financial subsidiaries in all jurisdictions including Denmark, with no regard to the subsidiary's tax burden.

If applicable, the C.F.C. regime provides that a Danish shareholder of the C.F.C. must include the total taxable income of the C.F.C. The Danish shareholder may, however, offset any taxes paid by the subsidiary. If the shareholder does not own the entire share capital of the C.F.C., the Danish shareholder will include only his *pro rata* share of C.F.C.'s income.

In general, the C.F.C. regime applies if the following three conditions are met:

- The Danish company and the foreign subsidiary are group-related (see **Thin Capitalization** below). Generally, group-relation exists if the Danish company directly or indirectly holds more than 50% of the foreign subsidiary's voting rights;

- The C.F.C. income comprises more than half of the aggregate taxable income of the foreign subsidiary; and
- The subsidiary's financial assets represent more than 10% of its total assets.

C.F.C. income is conclusively defined in the law and includes:

- Net interest income;
- Net gains on receivables, debts, and financial instruments;
- Certain commissions;
- Dividends;
- Net capital gains on shares, but only to the extent that they are taxable under Danish law. Consequently, dividends and capital gains that benefit from the Danish participation exemption are not considered to be tainted income;
- Royalty payments and capital gains arising from intellectual property rights, unless the intellectual property arose from the subsidiary's own research and development activities and the payments in issue are made by an unrelated party;
- Deductions claimed for tax purposes by a Danish company that relate to the income items listed above;
- Leasing income deriving from financial leases including losses and gains on the assets involved;
- Income from insurance, banking, and other financial activities, unless an exemption is otherwise applied for; and
- Gains and losses from sale of CO_2 credits and CO_2 quotas.

The assessment is made on the basis of the facts that occur during the year. Losses from previous years that are eligible to be carried forward and group contributions are not taken into account when computing the foreign subsidiary's total income or its C.F.C. income.

If the C.F.C. is, itself, the shareholder of other, lower-tier subsidiaries in the same jurisdiction, all computations are made on a consolidated basis. As a result, dividends from other, lower-tier subsidiaries and capital gains realized from the disposition of the shares of those subsidiaries are disregarded when computing the income threshold.

When making an assessment of whether the subsidiary's financial assets represent more than 10% of its total assets, the following financial assets are not included:

- The financial assets on which the yield/gains are tax exempt, such as Subsidiary Investments where the subsidiary owns at least 10% of the share capital, and the subsidiary is not considered as a trader in securities; and
- The shares in lower-tier subsidiaries, which are controlled by the subsidiary and located in the same jurisdiction as the subsidiary. Instead, the financial assets in the lower-tier subsidiaries are included proportionately in accordance with the subsidiary's direct or indirect ownership share.

CAPITAL GAINS TAXATION

Danish-resident companies are exempt from tax on gains realized on shareholdings of 10% or more. Capital gains realized by a Danish-resident company on shareholdings below 10% in a non-listed company are generally also tax exempt.

However, these rules do not apply if the Danish company is a trader in securities and the shares are acquired for trading purposes. A trader in securities is defined as a person that is engaged in the business of selling and buying securities on a systematic, professional, and extensive basis. Any such gains or losses are included in taxable income for a trader. Shares are considered bought for trading purposes if the shares have been bought by the trader in the course of the trader's business with the purpose of reselling the shares for a profit.

Share gains derived by a Danish company that do not qualify for tax exemption are subject to tax at the standard corporate income tax rate of 23.5% (22% in 2016 and onwards).

In general, a nonresident company is exempt from Danish tax on gains realized on shares in a Danish company. However, payment received, or deemed to be received, by a foreign entity in connection with an intra-group transfer of Danish shares will be characterized as a taxable dividend payment if:

- The foreign entity transfers shares held in a group-related Danish entity to another group-related entity for consideration consisting of valuables other than shares in the receiving group entity, and
- The transferring foreign entity would not have qualified for exemption from Danish withholding tax on dividends received from the transferred Danish entity prior to the transfer.

If the above criteria are met, payment received, or deemed to be received, by a foreign entity as consideration for Danish shares will be subject to Danish dividend withholding tax of 27%. This rate may be reduced by treaty.

Further, an anti-avoidance rule dictates that payments received by a foreign entity in connection with a transfer of shares will be considered as a taxable dividend payment if:

- The receiving company is without any economic risks from commercial activity;
- The payment consists of valuables other than shares in the receiving group entity; and
- The transferring foreign entity is not qualified for an exemption from Danish withholding tax on dividends received from the transferred Danish entity prior to the transfer.

In order to prevent circumvention of the anti-avoidance rule through intercompany sales, commercial activity acquired from a related legal entity less than three years before the sale of shares is not regarded under the "economic risk assessment." The definition of a related legal entity can be found the following section in **Thin Capitalization**.

A company without any economic risks from commercial activity is a company where the commercial activity has stopped or where the commercial activity is insignificant.

INTEREST DEDUCTIBILITY LIMITATIONS

Interest expense incurred by corporations is generally deductible in computing taxable income if the debt involves a binding legal commitment. Interest paid to related parties must be calculated on an arm's length basis. Interest expense incurred on certain debts owed to the government is not tax deductible. An example of nondeductible interest is the interest that accrues on unpaid tax.

Thin Capitalization and Other Limitations

Denmark has enacted thin capitalization rules regarding intercompany debt, which may limit the deductibility of interest on debt owed to group-related entities ("Controlled Debt"). These thin capitalization restrictions apply only to the extent that the Danish company has Controlled Debt exceeding a *de minimis* threshold of DKK 10,000,000 (approximately €1,341,000). Further, the thin capitalization rules only apply to the extent that the debt to equity ratio exceeds 4:1. In such a case, the limitation of interest deduction applies to that portion of the Controlled Debt that exceeds the 4:1 threshold. Taxpayers that have such excess debt are typically advised to convert the excess into equity in order to avoid the limitation of deductibility.

For the purpose of the thin capitalization rules, Controlled Debt means debt owed by a Danish debtor company (the "Danish Debtor") to a Danish or foreign related legal entity. A related legal entity is a legal entity that:

- Is controlled by the Danish Debtor;
- Controls the Danish Debtor; or
- Is group-related with the Danish Debtor.

Control means that more than 50% of the shares or voting rights are owned or controlled, directly or indirectly. When determining whether the lender *controls* the Danish Debtor (or *vice versa*), votes and shares held by all group-related entities are taken into account. Votes and shares held by unrelated shareholders may also be taken into account if an agreement has been made between the lender and the unrelated shareholders for the purpose of "*exercising a common controlling influence*" over the Danish Debtor.

Group-related entities mean two or more entities that are (i) directly or indirectly controlled by the same group of shareholders or (ii) under common management. The lender and the Danish Debtor may be considered to be *group-related* by virtue of common management if they have the same manager or if they have different managers that have entered into an agreement providing for a common management of the lender and the debtor.

Not only taxable legal entities are considered under the above definitions. Fiscally transparent entities may be considered if they "are governed by rules of corporate law, a corporate law agreement or articles of association." Such entities may, for these purposes, be treated as entities that have separate legal personality and identity for tax purposes.

Finally, Controlled Debt means debt to an unrelated entity, when a related entity has provided credit support. A back-to-back loan is regarded as credit support.

In addition to the foregoing, the Danish corporate tax regime includes two limitations on the deductibility of financial expenses related to controlled debt and third-party debt.

Thus, the deductibility of interest expense and other financial expenses incurred by a Danish company is subject to three limitations (applied chronologically as follows):

- A limitation based on debt-to-equity ratio (*i.e.*, the thin capitalization rules);
- A limitation based on the tax value of assets ("Asset Limitation Rule"), entailing that net financing expenses exceeding DKK 21,300,000 (approximately €2,762,000, (2012 figure)) are deductible up to a cap equal to the combined value of (i) 4.1% (2015 figure) of the tax base of Danish operating assets and (ii) 5% (2015 figure) of the value of foreign subsidiaries; and
- A limitation based on annual profits ("E.B.I.T. Limitation Rule"), entailing a maximum interest deduction of 80% of E.B.I.T. The limitation only applies if the net financing expenses exceed DKK 21,300,000 (approximately €2,762,000 as of 2015).

Calculation of Net Financial Expenses

For the purpose of the Asset Limitation Rule and the E.B.I.T. Limitation Rule, net financial expenses are calculated as the sum of:

- Taxable interest income and deductible interest expenses (excluding interest income/expenses from trade debtors and creditors);
- Loan commission fees and similar expenses;
- Taxable capital gains and losses on claims, debts, bonds, and financial instruments (excluding gains/losses on claims acquired in trade if the contracting party is a related party);
- Gains/losses on forward contracts relating to the hedging of operating income (provided that the forward contracts are not acquired in trade);
- Deemed finance charges relating to financial leasing arrangements (defined in accordance with I.A.S. 17);
- Taxable capital gains and deductible capital losses; and
- Taxable dividends.

"The deductibility of interest expense and other financial expenses... is subject to three limitations."

Interest expenses and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses. The calculation of net financial expenses is made on a group basis for Danish companies, which are subject to Danish tax consolidation. If the Danish company/group has net financial expenses exceeding the DKK 21,300,000 threshold, such net financial expenses will be subject to restrictions under the Asset Limitation Rule and the E.B.I.T. Limitation Rule as discussed below.

Restrictions Under the Asset Limitation Rule

Net financial expenses in excess of DKK 21,300,000 will only be deductible by an amount corresponding to 4.1% of the tax value of certain assets.

For the purpose of computing the 4.1% ceiling, only certain qualifying assets are considered, including, *inter alia*:

- The tax book value of depreciable assets;
- The acquisition price on non-depreciable assets;
- Carryforward tax losses; and
- The net value of work-in-progress and account receivables.

Shares are not considered as qualifying assets, with the exception of shares in directly-owned foreign subsidiaries, which may be included up to 5% (2015 figure) of the acquisition price (subject to certain price adjustments). The partial inclusion of the directly-owned foreign subsidiaries is being phased out by 2.5% each year, starting with a qualifying inclusion ratio of 17.5% in 2010 and ending with 0% in 2017.

"Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company."

Claims, notes, and financial instruments are not considered as qualifying assets, either. This means that the value of the FX notes to be purchased by Danish Newco will not be included in the computation of the 4.1% ceiling. For companies subject to Danish tax consolidation, the computation of the 4.1% ceiling will be made on a consolidated basis.

Net financing expenses that are restricted under the Asset Limitation Rule will generally be lost, in that they cannot be carried forward. However, restricted losses on claims, notes, and financial instruments may be carried forward and set off against future capital gains of a similar nature realized within the following three accounting periods.

In addition to the limitations triggered by the thin capitalization rules and the Asset Limitation Rule, a company's or a group's net financial expenses must not exceed more than 80% of Earnings Before Interest and Tax ("E.B.I.T.").

Net financing expenses below DKK 21,300,000 will never be restricted under the E.B.I.T. Limitation Rule (but may be restricted under the thin capitalization rules which, however, only apply on controlled debt). The DKK 21,300,000 ceiling (which is adjusted annually) is calculated on a group basis for Danish companies that are subject to Danish tax consolidation.

In comparison to the Asset Limitation Rule, net financial expenses that are restricted by the E.B.I.T. Limitation Rule may be carried forward.

WITHHOLDING TAX ON OUTBOUND DIVIDENDS

Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for an elimination or reduction of the Danish withholding tax by virtue of the E.U. Parent-Subsidiary Directive (as amended by Council Directive 2003/123/EC) or a tax treaty between Denmark and the parent company's state of residence. If these conditions are not met, a 27% withholding tax is levied, subject, however, to subsequent refund if a lower rate is provided by treaty.

TIGHTENING OF DANISH RULES FOR EXEMPTION OF DANISH DIVIDEND WITHHOLDING TAX

"The dividend withholding tax exemption will not apply, where the Danish company acts as a conduit from one foreign corporation to another."

In recent years, the Danish tax authorities have sought to narrow the scope of the withholding tax exemption by limiting the benefit to corporate shareholders that qualify as "beneficial owners" of dividends. Now, the Danish Parliament has introduced an anti-avoidance provision under which the dividend withholding tax exemption will not apply, where the Danish company acts as a conduit from one foreign corporation to another. The provision is applicable when the dividend distributed by a Danish company to its foreign corporate shareholder constitutes an "on-payment" of dividends received from a foreign subsidiary. In that set of circumstances, the Danish company does not qualify as the beneficial owner of the dividend from the foreign subsidiary and the dividend paid to the foreign shareholder will not be exempted from tax, but will be subject to tax at the applicable treaty rate.

The legislative notes to the provision explain that the definition of the beneficial owner used in the O.E.C.D. model income tax convention will apply in determining whether the Danish company is the beneficial owner or merely a conduit. It can be inferred from the legislative notes that a Danish holding company will generally not qualify as the beneficial owner of dividends received.

The provision is not applicable if the corporate shareholder of the Danish company is entitled to the benefits of the E.U. Parent-Subsidiary Directive. The new provision will therefore only affect corporate shareholders resident in jurisdictions that have a tax treaty with Denmark, such as the U.S.

BASE AND EROSION PROFIT SHIFTING ("B.E.P.S.")

Denmark has already implemented many B.E.P.S. Actions in Danish law, and is accordingly well ahead of the O.E.C.D. schedule for implementation.

With respect to Action 2 on hybrid mismatches, see **Interest Withholding Tax and Check-the-Box Countermeasures** below for discussion of Section 2A of the Danish Corporation Tax Act, which has been enacted to counteract U.S.-Danish check-the-box structures. Further, debt to foreign persons or entities is deemed equity if the debt is treated as equity in the lender's country of residence. This rule is not triggered if the lender is taxed on the yield as interest in the lender's country of residence.

With respect to Action 3, see **C.F.C. Taxation** above. As described, Denmark has implemented detailed C.F.C. rules, which are generally wide in scope.

With respect to Action 4, see **Interest Deductibility Limitations** above. As is evident, Denmark operates strict measures to counteract base erosion through the use of excessive interest payments. These rules are supplemented by the anti-avoidance rule mentioned above, whereby debt to foreign lenders is treated as equity in Denmark if the loan is treated as equity in the lender's country of residence. Denmark also employs an aggressive approach when assessing the terms of intra-group loans, and will generally challenge excessive interest payments out of Denmark.

With respect to Action 5, Denmark has concluded a number of treaties on exchange of information with various tax havens to ensure a well-founded basis for taxation in Denmark.

With respect to Action 6 on preventing treaty abuse, see the following section, which outlines the contents of two newly introduced general anti-abuse clauses. As these treaty abuse rules are only recently adopted, the scope of their implementation is not yet clear.

With respect to Actions 8, 9, and 10, see **Transfer Pricing** below for discussion of the Danish transfer pricing rules. The arm's length principle in Danish law is defined in accordance with O.E.C.D. guidelines, and the Danish tax authorities recognize the methods set out in the guidelines.

GENERAL ANTI-ABUSE CLAUSES[4]

Denmark has adopted two new general anti-abuse rules ("G.A.A.R.'s") as of May 1, 2015: an E.U. tax directive G.A.A.R. and a tax treaty G.A.A.R.

The E.U. tax directive G.A.A.R. applies to cross-border transactions that fall within the Parent-Subsidiary Directive (2011/95/EC); the Interest and Royalty Directive (2003/49/EC) and the Merger Directive (2005/56/EC). The E.U. tax directive G.A.A.R. implements the mandatory G.A.A.R. of the Parent-Subsidiary Directive (amendment by Directive 2015/121).

The tax treaty G.A.A.R. is worded slightly differently than the E.U.-tax treaty G.A.A.R., but will presumably be interpreted to have the same content. With the enactment of the tax treaty G.A.A.R., Denmark has moved ahead of B.E.P.S. Action 6 in this respect.

"Denmark has adopted two new general anti-abuse rules ('G.A.A.R.'s') as of May 1, 2015: an E.U. tax directive G.A.A.R. and a tax treaty G.A.A.R."

The newly introduced G.A.A.R.'s entail that taxable persons will not benefit from the Parent-Subsidiary Directive, the Interest and Royalty Directive, the Merger Directive, and tax treaties if the principal purpose of a transaction or arrangement is to achieve a tax benefit which is not in accordance with the directives or the tax treaty and which is artificial in nature.

Thus far, the Danish courts have applied certain measures to disregard transactions carried out for tax purposes (namely the "substance over form" doctrine).

The explanatory remarks accompanying the newly introduced bill state that the new G.A.A.R.'s may have a wider scope than the existing doctrine of "reality in transactions," but fail to specify in which situations the G.A.A.R.'s are applicable.

The newly introduced G.A.A.R.'s raise serious uncertainty with respect to international tax planning, as it is unclear to what extent the Danish tax authorities can and will try to deny the benefit of the E.U. Tax Directives and double tax treaties to taxable persons seeking to reduce tax liability.

It is expected that Danish tax authorities will issue further guidance on how the G.A.A.R.'s are to be applied in practice. Until then, great uncertainty remains.

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[4] The general anti-abuse clause was enacted with Bill no. 540 of April 29, 2015, which was put into effect on May 1, 2015.

INTEREST WITHHOLDING TAX AND CHECK-THE-BOX COUNTERMEASURES

As a starting point, a 22% withholding tax applies to interest payments made by a Danish company to a foreign related entity.[5] However, a foreign related lender will be exempt from Danish interest withholding tax if it falls into one of the following categories:

- The foreign related lender has a permanent establishment in Denmark to which such interest income is attributed;
- The foreign related lender is protected under the Interest/Royalty Directive (2003/49/E.U.) (no tax is levied and no withholding tax applies);
- The foreign related lender is protected under a tax treaty with Denmark (irrespective of treaty rate);
- The foreign related lender is controlled (as defined under Danish C.F.C. rules) by a Danish entity;
- The foreign related lender is controlled by a party resident in a country that has concluded a tax treaty with Denmark, and further, that such country may tax the lender on such interest payments pursuant to C.F.C. taxation rules of that country; or
- The foreign controlling or group related lender can demonstrate that it has paid foreign income tax on the interest received at a rate of at least 17.625%, equivalent to three-fourths of the normal Danish flat corporate tax rate, and further provides that it has not entered into a back-to-back loan with an entity that has paid foreign income tax on the interest received at a rate of less than 17.625%.

The interest withholding tax rule is part of a dual regime, which aims to curb international tax planning based on leveraged structures where the foreign lender is not taxed on the interest income received from a Danish company. Together with the interest withholding tax rule, a special rule (Section 2A of the Corporation Tax Act) limits the deductibility of certain cross-border payments made to foreign group-related entities resident in an E.U./E.E.A. or treaty state. The primary aim of Section 2A is to counteract certain U.S.-Danish check-the-box structures.

The mechanisms of Section 2A can be summarized as follows. A Danish company or a foreign company with a permanent establishment in Denmark would be deemed transparent for Danish tax purposes if:

- The Danish company, according to the rules of a foreign state, is treated as a fiscally transparent entity, whereby the income of the company is included in the taxable income of a controlling foreign legal entity, *i.e.*, an entity that owns directly or indirectly more than 50% of the Danish company or holds more than 50% of the voting rights;[6] and
- The foreign state in question is an E.U./E.E.A. member state or has a tax treaty with Denmark.

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[5] See the definition of related legal entity in **Thin Capitalization**.

[6] See the definition of control in **Thin Capitalization**.

If these conditions are met, the Danish company would, for Danish tax purposes, be classified as a transparent entity, and consequently, be treated as a branch of the controlling foreign entity. Being treated as a branch, the Danish company would not be entitled to take a deduction for payments made to the foreign parent company or to other group-related entities that are treated as fiscally transparent by the foreign parent company. (See modification immediately below.) The payments would be considered to be within the same legal entity. This also means, however, that irrespective of the general requirements, dividend payments made to the foreign parent company would not be subject to any Danish withholding tax.

As an exception to the general rule outlined above, payments made by a Section 2A company to other group-related entities that are treated as fiscally transparent by the foreign parent company remain tax deductible if the receiving group-related entity is a tax resident of an E.U./E.E.A. or treaty state and that state is different from the state where the parent company is resident. It should be noted that Section 2A only applies when the Danish company and all intermediate holding companies above the Danish company are treated as fiscally transparent by the foreign parent company. The rule would not apply if the Danish company were owned by the foreign parent company through an entity resident in a third state and the income of that entity was not included in the taxable income of the foreign parent company.

Further, it should be noted that certain tax consolidation rules, such as those in the U.S., may be considered to have the same effect as fiscal transparency and therefore may trigger Section 2A status. The paradigm is a U.S. company that has a branch in Denmark. The U.S. company or head office may be deemed transparent under Section 2A if the head office is tax consolidated with a U.S. parent company. In such an event, payments made by the Danish branch to the U.S. parent company would be considered to be within the same legal entity and thus not deductible.

A Danish company that has been classified as a transparent entity under Section 2A will not be considered a Danish tax resident and thus will not be entitled to the benefits of E.U. directives and tax treaties concluded by Denmark.

TRANSFER PRICING

Under Danish law, transactions between related parties must be carried out in accordance with the arm's length principle. The arm's length principle is defined in accordance with O.E.C.D. guidelines and the Danish tax authorities recognize the methods set out in the guidelines.

When filing its tax returns, a Danish company must report the type and scope of transactions with related legal entities. In addition, a Danish company is required to prepare and keep documentation on the methods used in determining the prices and terms of the transactions with related parties. Documentation may be prepared in Danish, Swedish, Norwegian, or English.

Small and medium-sized companies are relieved of the obligation to prepare documentation. These businesses are only required to prepare documentation for transactions with related companies resident outside the E.U., and only if Denmark does not have a double tax treaty with the country in question. Small and medium -sized companies include companies which, on a consolidated basis, have (i) less than 250 full time employees during a year and (ii) either assets below DKK 125,000,000

(approximately €16,757,000 as of June 8, 2015) or turnover below DKK 250,000,000 (approximately €33,500,000 as of June 8, 2015).

The penalty for noncompliance is calculated on different objective criteria and based on the potential tax advantage. However, a fixed penalty of DKK 250,000 (basic amount) applies, plus 10% of the increased income if noncompliance resulted in economic gain.

The Danish tax authorities are now allowed to request a special auditor's statement concerning transfer pricing documentation. It is a condition for the tax authorities' request that the company has controlled transactions with low-tax countries or the company's annual reports have shown average operating losses for the previous four years measured at the E.B.I.T. level.

GROUP OF COMPANIES – JOINT CROSS-BORDER TAXATION

Under the Danish tax consolidation regime, Danish companies and Danish branches of foreign companies, which are group-related as defined below, are subject to mandatory Danish tax consolidation. Foreign branches of Danish companies in the group are not included unless an election for cross-border tax consolidation has been made. With respect to cross-border tax consolidation, the all-or-none principle applies. While tax consolidation with foreign group companies is voluntary, the all-or-none principle means that either (i) all group entities (Danish and foreign) are included in the tax consolidation scheme or (ii) none of them is included. The decision to form a cross-border tax consolidation group is binding for a period of ten years. In the event the consolidation is terminated within the ten-year period, foreign tax losses which were deducted are fully recaptured.

The regime applies to all related companies meeting the definition of group-related companies set out in the Danish Financial Statements Act. Consequently, a qualifying group-relation exists if a company, foundation, association, trust, or other entity:

- Has the majority of the voting rights in another company;
- Is a shareholder and has the right to appoint or dismiss a majority of the members of another company's management;
- Is a shareholder and is entitled to exercise control over another company's operational and financial management on the basis of the articles of association or agreement with that other company;
- Is a shareholder and controls the majority of the voting rights in another company on the basis of a shareholder's agreement; or
- Is a shareholder in another company and exercises control over that company's operational and financial management.

The basic principles for determining and calculating consolidated income tax have not changed. The administration company and the entities of the tax consolidation in which all the shares are directly or indirectly owned by the ultimate parent at the end of the income year are jointly and severally liable with the parent company for the tax charges plus the surcharges and interest allocated to the company in that income year.

The taxable income of the consolidated group is computed company by company. The consolidated income is created by netting out the taxable results so that losses in one company offset profits in another. Losses incurred by a group company before entering into the tax consolidation scheme cannot be set off against the taxable profits of other group companies, but only against its own future profits. Tax consolidation does not eliminate capital gains that arise from the transfer of fixed assets between group companies, and there are no other special provisions exempting such gains from corporate income tax.

The ability to claim a benefit from a loss carryforward is limited. A loss of DKK 7,500,000 million (as adjusted annually) can be offset against positive income in the carryover year. The remaining loss can reduce up to 60% of the remaining income. Any remaining loss can be carried forward indefinitely. Net operating loss carrybacks are not allowed.

"Danish corporate law allows for distribution of interim dividends."

Special transition rules apply with regards to the recapture of foreign tax losses upon the termination of a tax consolidation scheme established under the old regime.

INTERIM DIVIDENDS

Danish corporate law allows for distribution of interim dividends. Interim dividends may be distributed several times a year; however, interim dividends can only be distributed after the publication of the company's first financial year. Interim dividends may be distributed out of the free reserves and the profits realized in the current year as of the date of the interim balance sheet. While ordinary annual dividends are distributed only upon the decision of the general shareholders' meeting, the decision to distribute interim dividends can also be made by the board of directors pursuant to an authorization given by the shareholders. The authorization does not have to be stipulated in the company's articles of association, but many shareholders choose to include such authorization provisions in the articles of association to evidence that an authorization has been issued.

BINDING ADVANCE RULING

Binding rulings, including advance rulings, on specific proposed transactions can be obtained from the Danish Tax Authority. A fee (currently approximately €50) is charged for a binding ruling. Persons not subject to Danish tax liability are also entitled to ask for binding rulings. Binding rulings are generally issued within one to three months, but might be issued much later for complex issues. Binding rulings can be appealed to either the National Tax Tribunal or to a tax appeal committee, whose decisions can be appealed to the City Courts and the High Courts.

The binding ruling will be binding for the tax authorities for a period of five years. However, it is possible for the tax authorities to shorten the period if required by the circumstances. The ruling is binding to the extent that the facts presented by the taxpayer upon submission of the request for the ruling do not differ from the actual facts of the transaction.

As of May 1, 2015, binding rulings on the value of an asset transferred will no longer be binding if the value subsequently deviates significantly from the value set in the binding ruling. A significant deviation is at least DKK 1,000,000 (€134,000) and at least 30%.

The assessment of whether or not the value of an asset has deviated from the time the binding ruling was issued may be based on either subsequent sale prices obtained by the buyer of the asset (via a direct or indirect sale), or the revenue subsequently generated by the asset. The binding ruling may be disregarded until the statute of limitations expires, and the tax authorities are allowed to take into consideration all activities that have taken place until this time. Binding rulings on the value of assets transferred are typically only relevant in transfer pricing cases. The statute of limitations for transfer pricing cases expires on May 1 of the sixth year following the relevant tax year, *e.g.*, the value of an asset transfer taking place in the tax year 2015 can be set aside until May 1, 2021, taking into account any developments during this time.

The tax authorities are obliged not to set aside a binding ruling if the subsequent changes to the value of the assets are due to developments, market changes, and so on, that neither could nor should have been taken into account when the asset's value was originally determined.

AUSTRIA

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INTRODUCTION

Austria, unlike countries such as Switzerland or Luxembourg, does not recognize a specific holding company status. Therefore, a holding company is taxed in Austria in the same way as any other company. Nevertheless, the following features of the Austrian tax system make Austria a favorable jurisdiction for international holding companies:

- An international participation exemption for dividends and capital gains received from foreign subsidiaries;
- No thin capitalization legislation;
- A competitive tax rate of 25%;
- No C.F.C. legislation;
- No withholding tax on interest paid by non-banks to nonresidents;
- No withholding tax on dividends paid to E.U.-resident parent companies;
- An extensive network of tax treaties (more than 80 treaties with, in particular, all major Austrian trading partners, Eastern European countries, and former member states of the U.S.S.R.) reducing or eliminating the general withholding tax rate of 25% on dividends;
- The possibility of obtaining advance tax rulings regarding reorganizations, group taxation, and transfer pricing issues;
- A group taxation system that allows Austrian holding companies to deduct losses incurred by qualifying foreign subsidiaries; and
- Full deductibility of interest expenses for loans in connection with the acquisition of subsidiaries that are not already members of the group.

CAPITALIZATION OF AUSTRIAN COMPANIES

Equity Contributions

Currently, equity contributions and profit participating loans to an Austrian company are subject to a one-time Capital Tax imposed at a rate of 1% if made by a direct shareholder of the company. Hence, contributions to a second-tier subsidiary by a shareholder of the parent company generally do not give rise to a capital charge even under current law. In addition, various exemptions are available, the most important of these being the exemptions for mergers and other reorganization measures provided by the Capital Tax Act and the Reorganization Tax Act. Effective

January 1, 2016, Capital Tax will be abolished. Until that time, careful tax planning should eliminate or reduce the Capital Tax burden on high equity contributions.

Loan Capital

It is noteworthy that Austria does not have a statutory thin capitalization rule. Loan arrangements between an Austrian company and one of its shareholders are generally recognized for tax purposes, provided that the terms of the loan meet the conditions of an arm's length test and that a third party would grant a similar loan in light of the financial situation of the company. If not, the loan capital will qualify as equity with the result that a Capital Tax of 1% is levied on the contribution (until December 31, 2015) and interest paid on the loan will not be deductible as a business expense, but instead be treated as a hidden distribution to the shareholder. In practice, under certain circumstances, debt-to-equity ratios of 98:2 are accepted as arm's length loan arrangements by the tax authorities.

Until December 31, 2015, profit participating loans will be subject to Capital Tax at the rate of 1% unless more than 50% of the interest is fixed (see **Equity Contributions** above).

CORPORATE TAXATION

In General

A company is resident in Austria for tax purposes if it has its legal seat or its effective place of management in Austria. Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 25%. Independent of the taxable income, a minimum tax of 5% of the statutory minimum share capital is levied (*i.e.*, €1,750 for limited liability companies and €3,500 for stock companies). During the first ten years after incorporation of a limited liability company, a reduced minimum tax applies for limited liability companies, namely €500 for the first five years and €1,000 for the following five years. Any minimum tax payments can be offset against higher tax burdens in the future without limitation.

A nonresident company is taxable on business income derived in Austria if it carries on a business through a permanent establishment in Austria or participates in such a business. Income and capital gains from Austrian real estate are also taxable as Austrian business income of the nonresident company, even if the real estate is not attributable to an Austrian permanent establishment.

A nonresident company is further taxable on certain other items of income from Austrian sources, in particular dividends from Austrian companies (if not exempted under the participation exemptions) or royalties.

Participation Exemption

Participation Exemption for Dividends Received from Austrian Corporations and Portfolio Participations in Foreign Corporations

Pursuant to Section 10/1 of the Austrian Corporate Income Taxation Act ("C.T.A."), dividends (or similar distributions of profits) received by an Austrian company from (i) another Austrian company or cooperative, (ii) comparable entities resident in the European Union, or (iii) comparable entities resident in any other country with which Austria has concluded a comprehensive mutual administrative assistance treaty are tax exempt, disregarding the extent or period of holding the participation.

The tax exemption for portfolio participations in foreign companies is not granted if the foreign entity is not subject to a tax comparable to the Austrian corporate income tax, the tax rate is less than 15%, or the foreign entity is subject to comprehensive tax exemptions. In these cases, the dividends paid are not tax exempt, but foreign tax paid is credited against Austrian tax (switchover).

However, capital gains from the sale of an Austrian domestic participation or a portfolio participation in a foreign corporation do not fall under the participation exemption and are subject to tax at the standard rate of 25%. Gains realized upon the liquidation of the subsidiary are treated as capital gains and not as dividends, with the result that the domestic participation exemption does not apply.

A different set of exemption provisions applies to participations in non-Austrian companies that qualify as international participations. These are discussed in the following section.

Participation Exemption for Qualifying International Participations

Qualifying International Participations

According to Section 10/2 C.T.A., a foreign company (including any company resident in the European Union or in the European Economic Area) is a qualifying international participation if the following conditions are met:

- The Austrian company holds, directly or indirectly through a transparent entity (*e.g.*, a partnership), at least 10% of the share capital of the foreign company;
- The shares have been held for a minimum period of one year; and
- The foreign company is comparable to an Austrian company or meets the requirements of Article 2 of the E.U. Parent-Subsidiary Directive.

"Qualifying international participations held by an Austrian company are entitled to exemptions from tax with regard to dividend payments received and capital gains."

Tax Exemptions

Qualifying international participations held by an Austrian company are entitled to exemptions from tax with regard to dividend payments received and capital gains.[1]

The tax exemption for dividends includes dividends and other distributions paid out of profits earned by the foreign company prior to the acquisition of the shares by the Austrian holding company.

Capital Gains

Capital gains (or losses) from the alienation of shares and from the liquidation of a foreign company are (generally) tax-neutral pursuant to Section 10/3 C.T.A. This system of tax neutrality means that capital gains or losses are disregarded and, therefore, not included in the tax base. Further, no tax deduction for a write-down of the value of the participation may be claimed. However, losses incurred in the course of the termination of the company (voluntary winding-up or insolvency) remain deductible, insofar as they exceed the tax-exempt income received during the five business years prior to the commencement of the winding-up or insolvency proceedings.

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[1] Sec 10/1 nr 7 C.T.A.

The system of tax neutrality of capital gains, losses, and write-downs does not apply if the Austrian holding company opts to include these items in its tax base. This option must be executed in the tax return filed for the business year in which the qualifying participation has been acquired. The option is irrevocable and extends automatically to any shares in the same company that the Austrian company may acquire later on.

Regarding a change in tax status by virtue of a subsidiary's transfer of domicile, the following provisions apply. Should a subsidiary become an "international participation" through the transfer of the Austrian subsidiary's seat to a foreign country, the difference between the book value of the participation and its higher going-concern value at the time of the transfer remains taxable in the case of a later sale of the participation. On the other hand, if a foreign subsidiary loses its "international participation" status by virtue of the transfer of its seat to Austria (provided that no election for the taxation of the capital gains and losses has been made as described above), the higher going-concern value at the time of the transfer is deemed to be the book value for the purpose of computing capital gains and losses.

This provides for tax planning opportunities. If it is expected that the value of a participation in an Austrian subsidiary will rise in the future, it may be advisable to transfer the seat of the subsidiary to a foreign jurisdiction; the difference between the going-concern value at the time of the transfer and the later sales price would then be tax free. Conversely, a foreign subsidiary for which no election to tax has been made could be transferred to Austria, if it is expected that its value will decrease in the future, with the result that a capital loss becomes deductible.

Anti-Avoidance Provisions

The tax exemption for international participations is not available where the company meets the following conditions, established under specific anti-avoidance provisions:

- The main business of the company consists of, directly or indirectly, deriving (i) interest income, (ii) rental income from movable tangible property (*i.e.*, rents from immovable property are not detrimental), or (iii) income from royalties or the alienation of participations (passive income). Dividend income derived, directly or indirectly, from an operating company is not considered passive income.

- The foreign taxation of the company is not comparable to the Austrian system of corporation taxation. According to the International Participation Ordinance of the Ministry of Finance, a foreign tax system is comparable to the Austrian system if the average tax rate of the foreign company computed in accordance with the principles of Austrian tax law exceeds 15%. Foreign taxes that are indirectly imposed on the income of the foreign company are taken into account when calculating the foreign average tax rate. If the 15% threshold is missed only because the foreign tax law allows a deduction of depreciations on fixed assets or a deduction of loss carryforwards that are not deductible under Austrian law, the foreign corporate taxation is nevertheless deemed to be comparable to the Austrian taxation.

In principle, the international participation exemption is denied only if adverse results are reached under both tests. However, if marginally favorable results are

reached under one test, and adverse results are clearly reached under the other test, the exemption will be denied.

If the participation exemption is denied, a switch-over to the credit method takes place. Consequently:

- Dividends and capital gains from the foreign company become taxable at the level of the holding company; and
- Upon application by the Austrian holding company, foreign corporate income tax on the profits of and withholding tax on the dividends from the foreign company are credited against the Austrian tax liability, which is charged on dividends and other income distributions received by the Austrian company. The tax credit is itself subject to Austrian tax, much like a Section 78 dividend gross-up under U.S. tax law.

For example, if the foreign dividend is 100 and the creditable foreign tax is 10, the Austrian tax charge would be 25 (25% of 100) without tax credit; should the Austrian taxpayer file the application for the tax credit, the Austrian tax charge will be 17.5 (25% of 110 minus 10).

In the event that the creditable tax is higher than the Austrian tax, the tax credit can be carried forward and will be available as a credit against future Austrian tax.

The participation exemption may also be denied under the general abuse of legal rights concept. Generally speaking, an abuse of a legal right occurs when a specific legal structure can only be explained by tax avoidance with regard to Austrian taxes. In connection with foreign subsidiaries of Austrian companies, the Austrian Administrative High Court ("*Verwaltungsgerichtshof*"), the highest tribunal in tax matters, frequently invokes this principle when it reaches the conclusion that a foreign subsidiary has no economic function whatsoever. In the case of an abuse of a legal right, the foreign subsidiary is treated as a transparent vehicle, with the result that its profits are directly taxed in the hands of the Austrian taxpayer.

Treaty Exemptions

As set out above, the domestic participation exemption regime is in some aspects more favorable than the international participation exemption, since there is neither a minimum shareholding requirement nor a minimum holding period. Under tax treaties that include an equal treatment clause, the Austrian company may enjoy the benefits of the international participation exemption for foreign companies resident in the jurisdiction of the treaty state, if the conditions for application of the domestic participation exemption are fulfilled. Such clauses appear in the double tax treaties with Ireland, Luxembourg, Sweden, and Turkey.

Interest Deduction

As a general principle, costs relating to tax-exempt income are not tax deductible in Austria. However, interest payments connected with the financing of (domestic or international) shareholdings (but not other financing costs, such as bank fees) are deductible despite the fact that income derived from such participations is tax exempt. As of 2011, a deduction is no longer granted for interest payments made in connection with financing for the purchase of intra-group participations, in order to hinder intra-group tax-avoidance structures.

Group Taxation

Effective January 1, 2005, a group taxation concept replaced the former *Organschaft* concept. Under the rules now in effect, it is possible to tax all profits and losses derived by the members of a tax group at the level of the group head. However, group taxation is an option that may be elected independently for each potential group member.

The group head must be (i) an Austrian company, (ii) an Austrian cooperative, or (iii) an Austrian-registered branch of a nonresident company or cooperative that is either an entity listed in Article 2 of the E.U. Parent-Subsidiary Directive (provided that it is comparable with an Austrian entity that qualifies as group head) or a company that is legally comparable to an Austrian company and has its seat and its effective place of management in a Member State of the European Economic Area. Several companies may act jointly as group head, provided that certain minimum holding requirements are met. Several entities may form a joint group head if certain participation thresholds are met.

Participating group members may be Austrian or comparable foreign companies or cooperatives; foreign entities, however, will qualify as a group member only if the financial integration requirement described below is exclusively fulfilled with regard to an Austrian group member or the Austrian group head.

"A group taxation concept replaced the former Organschaft concept...

All profits and losses of the Austrian members of the group are still calculated at the level of the group members."

To qualify as a member of a tax group, the group head or an Austrian group member must hold a direct or indirect participation of over 50% in the Austrian or foreign subsidiaries that shall be part of the tax group. In the case of a joint group head, one head company must hold at least 40% and the other head companies must hold at least 15% in the group member. The financial integration requirement must be met during the entire business year of the participating subsidiary. The Austrian group members must further file a written application with the revenue office, which binds the group members for at least three years.

All profits and losses of the Austrian members of the group are still calculated at the level of the group members, but they are taxed at the level of the group head. This treatment applies even when a person who is not a group member holds a minority stake in one of the participating subsidiaries. For this reason, it is necessary that the group members agree on compensation payments. These agreements need not be annexed to the filing; it is sufficient that the group members confirm that such agreements exist. The compensation payments themselves will be tax neutral in Austria.

With regard to foreign group members, losses – but not profits – are taken into account. For the purpose of Austrian group taxation, the foreign loss is computed in accordance with Austrian tax law; however, effective as of 2012, the deductible foreign loss is limited by the amount calculated in accordance with the applicable foreign tax provisions. When the foreign member can receive a credit in future years for the foreign loss against foreign profits in accordance with the rules of the foreign tax law (*e.g.*, by using a loss carryforward provision), then recapture rules apply. As a result, if such losses can be used abroad, the tax base of the group head will be increased by the amount of losses used abroad. Should the foreign member cease to be a member of the tax group, the tax base in Austria will be increased in an amount corresponding to the losses previously consolidated in

Austria but not yet used against foreign profits. If the foreign group member ceases to exist because of liquidation or insolvency and a definite capital loss is incurred by the parent company, the recaptured amount is reduced by those write-downs that were not tax effective during the period of group membership.

Previously, the group taxation regime applied to subsidiaries resident in E.U. Member States and to subsidiaries anywhere in the world, although in practice, accounting rules made it enormously difficult to integrate a foreign subsidiary into an Austrian tax group. Effective March 1, 2014, subsidiaries resident in non-E.U. Member States can qualify as group members only if the country of residence has entered into an agreement on mutual administrative assistance in tax matters with Austria.

A negative effect of the group membership is that a write-down of participations in the share capital of group members will not be deductible for tax purposes. Previously, this disadvantage had been partially offset by the fact that, for Austrian-resident companies, goodwill acquired by means of a share acquisition was written down. If the acquisition costs of a shareholding exceeded the net capital of the acquired company increased by hidden reserves of non-depreciable assets, the excess amount (capped at 50% of the acquisition costs) was capitalized and depreciated over 15 years. However, for acquisitions made after February 28, 2014, this depreciation of goodwill no longer applies.

B.E.P.S.: Disallowance of Interest and Royalty Payments

In line with international actions to be taken against B.E.P.S., as of March 1, 2014, interest and royalty payments made by Austrian corporations to related parties are no longer tax deductible if, at the level of the receiving entity, such payments are tax exempt or taxed at a rate of less than 10% (also taking into account tax credits), or if, at the level of the beneficial owner, the receiving entity is not the beneficial owner of the interest or royalty payment.

WITHHOLDING TAX ON OUTBOUND PAYMENTS

Dividend Payments

Generally, dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 25%. This tax rate will be increased to 27.5% effective January 1, 2016. Dividends paid by an Austrian company to its E.U.-resident parent are exempt from taxation under legislation implementing the E.U. Parent-Subsidiary Directive, if the parent company directly holds a participation in the Austrian subsidiary of at least 10% for a minimum period of one year. If payments are made before the minimum holding period has elapsed, the payment is subject to withholding taxation; the parent company, however, is entitled to a refund once the minimum holding requirement has been met. In addition, tax must be withheld in cases of suspected abuse according to Section 94, nr. 2 of the Austrian Income Tax Act ("I.T.A."). In particular, abuse is assumed if the parent company is not actively engaged in business and does not have a number of employees or its own office. In such cases, withheld tax is refunded on application of the parent company provided that the abuse presumption is rebutted.

Under most tax treaties, withholding tax is ordinarily reduced to 15% for portfolio dividends and 5% for non-portfolio dividends. In some cases, withholding tax may be eliminated entirely (*e.g.*, Bulgaria). Austria has over 100 income tax treaties.

Austria has income tax treaties in effect with the following countries:		
Albania	Hong Kong	Philippines
Algeria	Hungary	Portugal
Armenia	India	Qatar
Australia	Indonesia	Romania
Azerbaijan	Iran	Russia
Barbados	Ireland	San Marino
Bahrain	Israel	Saudi Arabia
Belarus	Italy	Serbia
Belgium	Japan	Singapore
Belize	Kazakhstan	Slovakia
Bosnia & Herzegovina	Kuwait	Slovenia
Brazil	Kyrgyzstan	Spain
Bulgaria	Latvia	South Africa
Canada	Libya	South Korea
Chile	Liechtenstein	Sweden
China	Lithuania	Switzerland
Croatia	Luxembourg	Syria
Cuba	Macedonia	Tajikistan
Cyprus	Malta	Thailand
Czech Republic	Mexico	Tunisia
Denmark	Moldova	Turkey
Egypt	Mongolia	Turkmenistan
Estonia	Morocco	Ukraine
Finland	Nepal	United Arab Emirates
France	Netherlands	United Kingdom
Georgia	New Zealand	United States
Germany	Norway	Venezuela
Greece	Pakistan	

Capital Gains

Nonresident shareholders are generally subject to taxation on the disposition of shares in an Austrian company if the shareholder has held 1% or more of the share capital for any time during the preceding five years. If the participation does not exceed this threshold, capital gains are not taxable. For corporate shareholders, corporate tax is levied at the regular corporate tax rate of 25% on the realized gains. Gains realized on the liquidation of an Austrian company are subject to corporation tax, regardless of the extent of the shareholding.

"Austria has waived its right to tax capital gains from the disposal of shares under most of its tax treaties."

However, Austria has waived its right to tax capital gains from the disposal of shares under most of its tax treaties as specified in the O.E.C.D. Model Convention.[2]

Royalties

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%; expenses are not deductible. However, under most tax treaties, the withholding tax is reduced or eliminated (*e.g.*, Germany, Poland, Hungary, and Croatia). If the receiving company is resident in an E.U. or E.E.A. Member State, expenses directly connected to the royalty income may reduce the withholding tax base. However, the withholding tax will be increased to 25% of the net base.

Austria has adopted the Interest and Royalties Directive. Section 99a I.T.A. applies to interest and royalty payments made to associated companies of a type listed in the Annex to the Interest and Royalties Directive or their permanent establishments located in an E.U. Member State. In all circumstances, the recipient must qualify as the beneficial owner of the payment.

Companies qualifying as parent, subsidiary, or sister companies are deemed to be "associated" for the purposes of this directive. The parent company must directly hold at least 25% of the capital of the subsidiary for an uninterrupted period of one year. Furthermore, all companies involved in the structure of the corporate body must be resident within the E.U. A company is treated as the beneficial owner of interest and royalties only if it receives payment for its own benefit and not as an intermediary (*e.g.*, an agent, trustee, or authorized signatory) for another person.

Royalties include payments of any kind that are received as consideration for the use of or the right to use (i) any copyright (whether literary, artistic, or scientific), software, patent, trademark, design, model, plan, secret formula, or process; (ii) information concerning industrial, commercial, or scientific matters; or (iii) industrial, commercial, or scientific equipment.

Section 99a I.T.A. further requires that (i) the right be related to the assets of the recipient company and (ii) payments qualify as tax-deductible expenses when made by a permanent establishment, although deductibility does not apply if a permanent establishment pays interest or royalties to its head office.

If at the time of the payment the holding requirement has not been met or the Austrian debtor company has not yet provided the required documentary evidence, the withholding tax can be refunded upon request. The Austrian tax authorities are

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[2] See Article 13/4 of the *O.E.C.D. Model Convention*.

further free to deny an exemption if a corporate group structure was established with the intention of tax avoidance (in which case, the Austrian company will be held liable for withholding tax if it applied the exemption).

Interest

Interest payments to non-Austrian residents are subject to Austrian tax as follows:

- Income from debt claims secured by Austrian real estate is subject to withholding tax at a rate of 25%.
- Effective January 1, 2015, interest payments made by banks to residents of non-E.U. Members States will be subject to tax in Austria at the rate of 25%. This means that foreign residents can no longer claim refunds of or exemptions from the Austrian withholding tax on interest income. Interest payments made to E.U.-resident natural persons are subject to the provisions of the E.U. savings directive.
- Interest payments to E.U. companies and permanent establishments are exempted according to Section 99a I.T.A. if the requirements of the Interest and Royalties Directive are met.

"Austria does not have C.F.C. legislation nor thin capitalization legislation...

Transfer pricing issues are dealt with in accordance with general anti-avoidance principles."

In the case of shareholder loans, special attention is given to proper structuring. Under the general anti-avoidance principles, the interest accruing on the loan may be subject to withholding tax as a hidden distribution of profits if the terms of the loan do not meet the requirements of an arm's length test.

Given the fact that Austrian tax law does not provide for statutory thin capitalization rules, debt financing is an attractive method for repatriating profits from an Austrian holding company to its foreign parent company.

Other Income

A 20% withholding tax is levied on fees for technical and commercial consulting services rendered by a nonresident. However, Austria waives its taxing rights under most tax treaties.

OTHER TAX ISSUES

Wealth Tax

Austria does not currently impose a wealth tax on Austrian companies or individuals. Future tax reforms may reintroduce a general wealth tax, which was abolished in 1994. The only wealth tax currently imposed is an annual tax on Austrian real estate.

Anti-Avoidance Legislation

There are only a few specific statutory anti-avoidance provisions in Austrian tax law, the most noteworthy being the aforementioned provisions relating to the international participation exemption. In particular, Austria does not have C.F.C. legislation nor thin capitalization legislation. Transfer pricing issues are dealt with in accordance with general anti-avoidance principles, in particular the arm's length principle.

However, there is a general anti-avoidance rule that provides for the principle of "substance over form." As a consequence of austerity budgets and international B.E.P.S. measures, in recent years this provision has been applied by the Austrian tax authorities more often and to a wider scope of transactions. Thus, tax planning has become challenging and tax consequences have become less predictable.

Foreign Tax Credit

By virtue of a Double Taxation Directive from the Ministry of Finance, certain items of foreign-source income are exempt from Austrian taxation, in particular income from immovable property, business income attributable to a foreign permanent establishment, and income derived from building sites or construction or installation projects, if the following requirements are met:

- The Austrian taxpayer derives income from sources in a country with which Austria has not concluded a tax treaty;
- The foreign state imposes a tax on the income that is comparable to Austrian income taxation or corporation income taxation; and
- The average foreign tax rate computed in accordance with Austrian tax principles exceeds 15%.

The credit method applies to all foreign-source income that is neither exempt from taxation according to the foregoing rule nor subject to a tax treaty. The foreign tax credit is capped at an amount corresponding to the part of the Austrian tax that is attributable, as computed before the deduction is given, to income from sources within the foreign country in question. There are, however, no "basket" rules for the foreign tax credit.

FRANCE

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CORPORATE INCOME TAX ("C.I.T.") – GENERAL

The standard C.I.T. rate in France is 33.33%. However, a 3.3% additional social contribution may apply on the fraction of the C.I.T. which exceeds €763,000 (*i.e.*, where the taxable profits are higher than €2,289,000). The effective tax rate in this case is therefore 34.43%. Lower rates apply to small- and medium-sized enterprises ("S.M.E.'s").

The 4th Finance Amendment Bill for 2011 introduced a temporary additional 5% contribution based on the C.I.T. amount due, which was meant to apply for three years. Its application has been extended through the fiscal year ending on December 30, 2016. Also, as of the 2013 fiscal year, the rate has been increased to 10.7%. This contribution only applies where the worldwide annual turnover of an entity exceeds €250 million. The effective C.I.T. rate amounts to 38%, taking into account this second additional contribution.

NET OPERATING LOSSES ("N.O.L.'S")

Carryforward

N.O.L.'s can be carried forward with no time limit. However, the amount of offset against the taxable result cannot exceed €1 million, plus 50% of the fraction of the taxable result exceeding €1 million.

Carryback

N.O.L.'s incurred by companies subject to C.I.T. can be offset against the taxable result realized in the immediately preceding tax year. Thus, a loss incurred in 2015, for example, can only be carried back and used against taxable income in 2014, with no ability to go further backward. Furthermore, the carryback is now limited to the lesser of €1 million or the taxable income realized in the immediately preceding tax year. The carryback gives rise to a tax credit, the amount of which is determined by applying the C.I.T. rate of the fiscal year during which the profit was realized to the amount of N.O.L.'s carried back. This tax credit can be (i) reimbursed at the end of the five-year period following the year during which the losses were incurred, (ii) used before that date for the payment of the C.I.T. (but not for the payment of the additional contributions to C.I.T.), or (iii) offered as a guaranty to a credit institution.

PARTICIPATION EXEMPTION OR THE DIVIDENDS RECEIVED DEDUCTION

Dividend distributions received by French corporations, whether French or foreign-sourced, are in principle included in C.I.T. taxable income. Under the Dividends Received Deduction regime ("D.R.D."), however, distributions are 95% exempt from C.I.T. where the following conditions are met:

- The shares are in registered form or deposited with an accredited institution;
- The receiving corporation holds at least 5% of the capital of the distributing company; and
- The qualifying 5% share in the capital of the distributing company must be held for at least two years.

"Dividend distributions received by French corporations, whether French or foreign-sourced, are in principle included in C.I.T. taxable income. Under the Dividends Received Deduction regime ('D.R.D.'), however, distributions are 95% exempt."

The 5% capital threshold refers only to financial rights as they have recently been defined in French case law.[1] This proves flexible where companies issue preferred stock with increased financial rights and reduced voting rights.

The exemption applies from the first day of the 5% holding, provided that the holding period is ultimately maintained for two years. Failure to maintain the shares for two years will result in a claw-back of the exemption. Late-payment interest along with the applicable C.I.T. must be paid within three months of the date of disposal of the shares. A disposal of shares within the course of a tax-free reorganization is disregarded for D.R.D. purposes.

Only dividends attached to stocks with both financial and voting rights are eligible for the 95% exemption. As an exception, where the receiving entity holds at least 5% of the financial rights and voting rights (and the two-year holding condition is met with respect to this share), all the dividends received benefit from the 95% exemption.

The D.R.D. regime applies to dividends and other distributions attached to the shares of stock held by the receiving corporation.

Dividends are fully exempt with a 5% add back of the costs deemed to correspond to management of the stock. N.O.L.'s can be applied against that taxable profit.

The D.R.D. applies to dividends received from foreign subsidiaries without limitation, other than those conditions set forth above. Subject to the application of tax treaties, foreign tax withheld in a source country may be used (no later than five fiscal years after the distribution) as a tax credit against any French withholding tax that may be due upon the further distribution of the dividend to a foreign shareholder of the French company.[2] Otherwise, tax withheld at the source is not recoverable. The 5% add back is calculated on the gross amount of the dividends received from the foreign subsidiary.

As of March 1, 2010, distributions from a company established in a non-cooperative country or territory (see **N.C.C.T.'s and the Black List** below) are not eligible for the D.R.D., except where the corporate shareholder justifies that its holding is effective and not driven by tax fraud.

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[1] C.E. November 5, 2014, decision No. 370650.

[2] French administrative doctrine; BOI-RPPM-RCM-30-30-20-50, September 12, 2012.

In anticipation of efforts against base erosion and hybrid instruments, the D.R.D. is no longer applicable for distributions made as of January 1, 2015, if the dividend gives rise to a deduction at the level of the distributing company. This provision also complies with the amendment of the European Parent-Subsidiary Directive on cross-border distributions within the Single Market, which prevents the exemption of the dividend at the level of the recipient corporation when the dividend was already allowed as a deduction against the profits of the distributing company.[3]

Last, but not least, for fiscal years closed on or after December 31, 2014, a transfer of qualifying stock to a "*Fiducie*," which is the equivalent of a trust under French law, is not treated as a disposal for D.R.D. purposes despite the apparent transfer of ownership. Through the trustee ("*fiduciaire*"), the settlor ("*constituant*") should maintain all its voting and financial rights on the stock. This development would allow the use of a Fiducie for leveraged buyouts ("L.B.O.'s") and would prove more flexible and less burdensome than the so-called "double luxco structure," which is not exempt from tax or legal challenges.[4]

TAX CONSOLIDATION

Under §§223A *et seq.* of the F.T.C., a French company, or a French branch of a foreign company, that holds, directly or indirectly (either through other French consolidated companies or, subject to certain conditions, through an E.U.-resident company[5]), at least 95% of the capital and voting rights of other French companies or branches of foreign companies may file a consolidated tax return.

The following conditions must be met:

- All members of the tax-consolidated group must be subject to French C.I.T. and have the same financial year;
- 95% or more of the consolidating company must not be held, either directly or indirectly, by another French company that is subject to C.I.T.;[6]
- The parent company must satisfy the 95% minimum holding, directly or indirectly, throughout the entire financial year; and
- Adequate tax group elections must be filed in a timely manner.[7]

The consolidating company is liable for C.I.T. on the group taxable result, which is the sum of all members' profits and losses, subject to certain adjustments such as the neutralization of intra-group transactions and distributions. Provided that they are paid after the first consolidated fiscal year, intra-group distributions, as

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[3] Council Directive 2014/86/EU of July 8, 2014 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[4] Amending Finance Law for 2014, No 2014-1655 of December 29, 2014.

[5] And companies situated in Norway, Iceland, and Liechtenstein.

[6] A French company subject to C.I.T. may indirectly hold a 95% participation in the consolidating company, provided that it is held through a company not subject to C.I.T. or through companies in which it maintains an interest of less than 95%.

[7] The filing deadline matches the deadline for filing C.I.T. annual returns.

well as the D.R.D. 5% add back (see **Participation Exemption or the Dividends Received Deduction** above), are also neutralized. The 3% distribution tax does not apply within a consolidated context (see **The 3% Contribution on Distributions** below).

"The 'Charasse Amendment' restricts the possibility to deduct interest expenses where a member of a tax-consolidated group purchases, from its controlling shareholders, shares of a company that subsequently becomes part of the same tax-consolidated group."

An anti-debt-push-down provision under §223B, known as the "Charasse Amendment," restricts the possibility to deduct interest expenses where a member of a tax-consolidated group purchases, from its controlling shareholders, shares of a company that subsequently becomes part of the same tax-consolidated group. In such a case, the acquiring company must add back part of its interest expenses for tax purposes during the year of the acquisition and the following eight years.[8]

Tax consolidation proves to be a powerful tool for L.B.O.'s since it combines consolidation and tax-free distributions.

The French tax consolidation regime has been modified in a favorable way during the last few years, thanks to rulings by the European Court of Justice ("E.C.J."). Since 2009, following the E.C.J.'s ruling in the *Papillon* case,[9] a consolidated group may include French subsidiaries indirectly held through a company (or permanent establishment) that is (i) resident in the E.U. or in the European Economic Area and (ii) subject to C.I.T., without exemption in its country of residence.

Further to E.C.J. case law,[10] the Amended Finance Law for 2014 introduced new provisions allowing the tax consolidation of French sister companies and their subsidiaries (under the conditions explained above) where at least 95% is held, directly or indirectly, by the same E.U.-resident company[11] subject to C.I.T. in its country of residence. In such a case, one of the two top sister companies elects to be treated as the consolidating company.

N.C.C.T.'S AND THE BLACK LIST

In order to bolster the fight against tax avoidance, the Finance Amendment Bill for 2009 established a black list of Non-Cooperative Countries and Territories ("N.C.C.T.'s"). A country or territory is defined as an N.C.C.T. if it meets the following criteria:

- It is not a Member State of the European Union;
- It has been reviewed and monitored by the O.E.C.D. global forum on transparency and exchange of information;
- It has not concluded 12 or more Tax Information and Exchange Agreements ("T.I.E.A.'s"); and
- It has not signed a T.I.E.A. with France.

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8 Interest expenses disallowed under the Charasse Amendment are determined on the basis of the following formula: (interest expenses of all tax group members) x (acquisition price / average indebtedness of all tax group members).

9 E.C.J., *Sté Papillon*, 418/07, November 27, 2008.

10 E.C.J., *SCA Group Holding BV*, C39-13, June 12, 2014.

11 Or in Norway, Iceland, or Liechtenstein.

The N.C.C.T. list is updated annually. At the time of this writing, the N.C.C.T. list as of January 1, 2015 has not yet been published.

As of January 1, 2014, the N.C.C.T. list includes the following states:		
Botswana	Guatemala	Nauru
British Virgin Islands	Marshall Islands	Niue
Brunei	Montserrat	

The N.C.C.T. list is subject to modification in accordance with developments concerning the conclusion of new tax treaties and/or the effectiveness of the exchange of information as provided by treaties and T.I.E.A.'s.

In cases where one of these countries is involved, the French tax law provides for an aggravated tax rate, tightened anti-abuse of law provisions, or exclusion from favorable tax regimes.

"Companies that are subject to C.I.T. are also subject to a contribution on the distributions made to their shareholders, whether French or foreign, equal to 3% of the distributed amount."

THE 3% CONTRIBUTION ON DISTRIBUTIONS

As of August 17, 2012, companies that are subject to C.I.T. are also subject to a contribution on the distributions made to their shareholders, whether French or foreign, equal to 3% of the distributed amount. This special contribution, treated as C.I.T. (and not as distribution tax), is not deductible.

S.M.E.'s or collective investment funds, and, under certain conditions, Real Estate Investment Trusts ("R.E.I.T.'s"), are not liable for the 3% contribution.

The special contribution applies to dividends and distributions as defined by French tax law. This contribution is not applicable to dividends paid in shares (if the shares are not cancelled[12] within one year by the issuing company). As of January 1, 2015, share buybacks can no longer trigger the 3% contribution, as those transactions now fall within the capital gain tax regime. Before that date, the income resulting from share buybacks could be partially regarded as a distribution. The allocation of profits from French permanent establishments to their foreign parents will trigger the 3% contribution, except where the foreign company is E.U.-resident and the allocated profits are subject to C.I.T. in the E.U. Member State without option or exemption.

This contribution is not applicable within a tax consolidation context. Unused tax treaty foreign tax credits (on inbound dividends) can be credited against the 3% contribution.

Since its enactment in French tax law, the 3% contribution has been criticized as failing to conform with E.U. law. The tax applies to French corporations that make distributions to an E.U. corporation that is a 95% shareholder. If the 95% shareholder is a French corporation that heads a French consolidated group, an exemption applies to distributions within the group. Also, the fact that the 3% contribution applies to subsidiaries and not to branches could constitute an infringement of the

[12] Through a share buyback program not aimed at purging losses of the company (under §§L225-207 of the Commercial Code).

E.U. freedom of establishment. In February 2015, the E.U. Commission initiated an infringement procedure against France in order to address these issues.

WITHHOLDING TAX ("W.H.T.") ON OUTBOUND DIVIDENDS

Under §119 *bis* 2 of the F.T.C., a 30% withholding tax is levied on outbound dividend payments subject to tax treaties (see Paragraph G.ii. below). Dividend payments made to N.C.C.T.'s are subject to a withholding tax of 75%.

In comparison, withholding is not required on dividends paid to qualifying E.U. parent companies subject to a 10% ownership test (the "E.U. Directive Exemption") or, where the E.U. parent company is unable to recover French-source withholding tax, subject to a 5% ownership test (the "5% E.U. Exemption"). In both cases, a two-year holding requirement applies.

Also, under certain conditions, withholding tax is not due when distributions are paid to collective investment funds established in the E.U. or in a country with which France has signed a convention on administrative assistance (which is the case with a large number of countries).

Outbound Dividends Within the E.U.

E.U. Directive Exemption

The E.U. Directive Exemption applies if the following tests are met:

- The distributing company is subject to C.I.T. (at the standard rate) in France without exemption;
- The shareholder corporation is an E.U. resident defined as having its place of control and management in another E.U. Member State;
- The shareholder corporation is incorporated under one of the legal forms listed as an appendix to the E.U. Directive 2011/96/EU dated November 30, 2011;
- The shareholder corporation is the beneficial owner of the dividends distributed;
- The shareholder corporation is subject to C.I.T. in its E.U. Member State of establishment, without option and exemption; and
- The shareholder corporation holds directly 10% or more of the capital of the distributing company. (The shares must be held for at least two years. However, the E.U. Directive Exemption can be claimed before the expiration of that period.)

The dividend may be paid to an E.U. permanent establishment of an eligible shareholder corporation.

An anti-abuse provision denies the E.U. Directive Exemption where a non-E.U. corporate shareholder directly or indirectly controls the beneficial owner, unless the beneficial owner can justify that the main purpose of the ownership structure does

not consist of taking advantage of the E.U. Directive Exemption (the "purpose test"). According to guidelines released by the tax authorities, the tainted purpose does not exist where the overall withholding tax cost through the ownership chain up to the non-E.U. ultimate controlling shareholder is equal to the withholding tax burden for which the non-E.U. controlling shareholder would have been liable had the dividend been paid directly to the non-E.U. controlling shareholder. The test is also satisfied if the ownership chain was in place before July 23, 1990 (*i.e.*, at the time the first E.U. directive was adopted).

5% E.U. Exemption

The 5% E.U. Exemption is provided for in F.T.A. guidelines[13] published in the wake of the E.C.J. *Denkavit* decision.[14]

The following requirements must be met:

- The shareholder must enjoy an exemption regime in its own country of residence. This is to say that the recipient shareholder must not be in a position to credit the French withholding tax against its own tax;
- The shareholder must be a resident of the European Union or of Liechtenstein, Norway, or Iceland,[15] provided that the recipient shareholder's country of residence has entered into a qualifying tax treaty with France;
- The parties must not have entered into an "artificial arrangement" for tax avoidance; and
- The stock must (i) constitute 5% of the capital and voting rights of the distributing company, (ii) be in registered shares or be kept by a financial establishment, and (iii) be held for at least two years.

When the above conditions are met, the French withholding tax exemption automatically applies.

In other words, if the qualifying shareholder is not taxed on the French-source dividends, as is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or greater interest in the French distributing company. If the dividend is taxed in the jurisdiction of residence of the E.U. shareholder, the dividend may still be paid gross if the E.U. qualifying corporate shareholder owns 10% or more of the French distributing company.

One may rely on tax treaty provisions, as an alternative to the 5% E.U. Exemption. Several tax treaties provide for zero withholding tax on dividends, including those with Spain, Germany, Japan, and the U.S.

"Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, ranging generally from 25% to 5%."

Outbound Dividends and Tax Treaties

Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, ranging generally from 25% to 5%. In addition, some tax treaties provide for zero withholding tax on dividends (see above). Also, some income tax

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13 BOI-RPPM-RCM-30-30-20-40, April 1, 2015.

14 E.C.J. *Denkavit*, C 170-05, December 14, 2006.

15 As members of the European Economic Area.

treaties have a narrow definition of dividends that restricts the application of the dividend provision only to distributions that qualify as a dividend under corporate law.[16] Consequently, distributions that are treated as dividends under tax law may not be covered by the "dividend" provision but, instead, for example, may fall under the "other income" provision, leading to a withholding tax exemption in France. An example is an exceptional distribution of reserves. As a consequence and to the extent that the other operative provision in the tax treaty applies, withholding tax may not be due. This situation may arise in the tax treaties with the Netherlands and Luxembourg.

CAPITAL GAINS TAX ON SHAREHOLDINGS – EXEMPTION

Gains on the sale of substantial shareholdings ("participation") are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for Capital Gains Tax ("C.G.T.") relief. Such relief is available in the form of an exemption or a reduced C.I.T. rate.

"Gains on the sale of substantial shareholdings...are treated as ordinary income unless... eligible for Capital Gains Tax ('C.G.T.') relief."

C.G.T. on substantial shareholdings covers gains on the disposal of participations, including shares or interests that the shareholder intends to hold as long-term investments, *viz.*, at least two years. They must be sufficient to provide the shareholder with control of, or significant influence over, the company; these tests are regarded as met with a 10% or greater interest. Stock eligible for the D.R.D. (5% interest) and stock received within the course of a Public Offering are also eligible. Shareholdings in N.C.C.T.-resident entities cannot qualify.

The exemption applies subject to a 12% add-back, which brings the effective tax rate to 4.13% of the gain, unless N.O.L.'s are available.[17] The 12% costs and charges share is calculated from the amount of exempted gross capital gains (capital losses are not taken into account). Disposals of shares in a listed real estate holding company ("S.I.I.C.," which is the French equivalent of a R.E.I.T.), of which more than 50% of the French assets consist of real estate, are eligible for the application of a 19% reduced C.I.T. rate, *i.e.*, a 19.62% effective tax rate, if the substantial shareholding requirements are met.[18] Disposal of shares of non-listed real estate holding companies are subject to the standard C.I.T. rate.

Capital gains resulting from the disposal of interests in venture capital funds or companies ("F.C.P.R." or "S.C.R.") that are held for at least five years are eligible for the C.G.T. exemption, but only in proportion to the investments made by the company and funds in qualifying substantial participations; otherwise, a 15% reduced C.I.T. rate applies (*i.e.*, a 15.45% effective tax rate).

For fiscal years closed on or after December 31, 2010, deductions for short-term capital losses incurred upon the transfer of shares held for less than two years to a

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16 CE October 13, 1999, *SA Banque Francaise de l'Orient*, RJF 12/99 #1587.

17 Where the company is subject to the 10.7% additional contribution, the effective tax rate is 4.56%.

18 This consists of the 19% tax rate increased by the 3.3% surcharge mentioned under **Corporate Income Tax ("C.I.T.") – General** above. Where the company is subject to the 10.7% additional contribution, this effective tax rate is 21.65%.

related party are deferred until the shares are effectively transferred to a non-related party.

OTHER TAX ITEMS

Deductibility of Interest Charges

Interest paid on a debt-financed acquisition of shares is deductible, even if the shareholder qualifies for a participation exemption on dividends[19] and C.G.T. relief.[20] This is, however, subject to several interest deductibility limitations.

Also, within a tax-grouping context, an anti-debt-push-down mechanism restricts the deductibility of interest.[21]

Interest Rate Test

Only interest paid at an arm's length rate can be considered tax deductible. When paid to an affiliate, interest expenses are tax deductible only within the limit of a rate corresponding to the average annual interest rate granted by credit institutions to companies for medium-term loans (*i.e.*, 2.79% for financial years ending on December 31, 2014). Interest expenses paid in excess of this limit are deductible only to the extent that the company establishes that they are arm's length.

However, these provisions are not applicable to interest paid to shareholders that qualify for the participation exemption regime on dividends.

Excess interest paid to affiliates under the interest rate test is treated as a distribution eligible for the participation exemption regime on dividends, or it may be subject to withholding tax (pursuant to the tax treaties) with resident lender affiliates. Some tax treaties may deny France the right to tax a deemed distribution where the dividend provision of the tax treaty does not encompass deemed distributions (see, *e.g.*, Luxembourg and the Netherlands).

Anti-Hybrid Rule

In an effort to curb the use of hybrid instruments, France has unilaterally introduced an anti-hybrid mechanism. This mechanism disallows interest deductibility in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax that would have been due in France (*i.e.*, at least 8.33% according to the French parliament, which corresponds to one-quarter of the 33.33% French C.I.T. standard rate[22]). The rate should refer only to the tax regime applicable to the gross income received from France, as opposed to the effective tax rate of the recipient entity. Expenses and losses that reduce the taxable result of the foreign company are not taken into account to the extent that the corresponding income is taxable at a rate of at least 8.33%. The

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19 See **The 3% Contribution on Distributions** above.

20 See **Withholding Tax ("W.H.T.") on Outbound Dividends** above.

21 See the Charasse Amendment discussed in **Tax Consolidation** above.

22 Under F.T.A. guidelines, the reference tax rate should account for additional contributions to C.I.T. to which the foreign company would have been subject if resident of France (BOI-IS-BASE-35-50, August 5, 2014).

guidelines do not provide for a case in which the recipient entity is itself indebted and serves a debt. French G.A.A.R. should also be considered.

Thin Capitalization

Related-party debt within the scope of the limitation includes debt extended by the controlling shareholder (either direct or indirect) and sister companies that are under control of the same shareholder ("Affiliates"). A shareholder directly or indirectly holding at least 50% of the capital of the French indebted company, or exercising control over the company's decisions, is regarded as controlling the company for purposes of the thin capitalization rules. Third-party debts that are guaranteed by related parties are assimilated to related-party debt for thin capitalization purposes. However, this extended scope does not apply to debts related to:

- Bonds offered to the public;
- Loans secured by a pledge, if the pledge is (i) over the shares of the borrower (*e.g.*, a parent company gives a pledge on shares of a French subsidiary to guarantee the loan granted by a bank to the subsidiary), (ii) on receivables held by the parent company on its direct subsidiary, or (iii) over securities of a direct or indirect shareholder of the borrowing entity, provided that the entity that grants the pledge and the borrower are members of the same French tax-consolidated group;
- Refinancing resulting from the mandatory repayment of pre-existing debt after a change of control of the borrower; or
- Loans contracted prior to January 1, 2011 for the purpose of an acquisition of securities, or refinancing contracted prior to January 1, 2011 for loans granted for the purpose of an acquisition of securities.

The test applies to Affiliates only. Two companies are regarded as Affiliates where (i) one holds directly or indirectly a majority in the capital of the other (legal control) or *de facto* controls it, or (ii) both companies are, within the same criteria, under the *de facto* or legal control of a third company.

It is then applied to the allowed fraction of the interest under the interest limitation rules explained above to determine if the interest expense is actually deductible.

Deductions claimed for interest expense will be disallowed when the creditor is an Affiliate and the following three tests are met:

- The related-party debt exceeds 1.5 times the amount of the net equity (taking into account related-party debt only);
- 25% of the operating profit before tax, related-party interest expense, depreciation, amortization, and certain specific lease payments is less than the actual related-party interest; and
- The interest paid to related parties exceeds the interest received from related parties.

The disallowed interest is equal to the highest of the above limitations. If it is less than €150,000 or if the disallowed interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group, the interest is allowed.

The disallowed interest can be carried forward to offset profits in the following years (up to 25% of the profits before tax, after the deduction of currently allowed related-party interest). The carryover is reduced by 5% each year from the second carryover year on.

"Deductions claimed for interest expense will be disallowed when the creditor is an Affiliate..."

The rules provide for two safe harbors. First, a 1.5-to-1 debt-to-equity ratio safe harbor is applicable, as seen above.

Second, a worldwide group safe harbor applies. Under the worldwide group safe harbor, the interest expense deduction will not be limited if the French borrower demonstrates that the disqualified interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group. Related-party debt and reciprocal transactions within the worldwide group should be set aside when computing the debt-to-equity ratio of the worldwide group. The worldwide leverage safe harbor does not allow for the leverage test to be divided by industry within the worldwide group, even though the degree of leverage generally differs from one industry to the next.

Interest exceeding the higher of the above limits is not tax deductible but may be carried forward within certain limits (they are deductible within the limit of 25% of the current income before taxation). Further, the interest deduction is reduced by 5% annually from the second year of the carryforward period. The excess interest is not regarded as a deemed distribution. No withholding tax should apply, especially where the recipient is treaty protected.

Among companies filing a consolidated tax return, the thin capitalization rules are applied at the level of each member on a stand-alone basis. The aggregate of disallowed interest may be deducted from the consolidated tax profit for an amount that does not exceed the difference between (i) the aggregate of the related-party interest paid by companies filing a consolidated tax return to non-consolidated entities and carryovers of pre-consolidation disallowed interest that was deducted during the consolidation and (ii) 25% of the operating profits of member companies before tax.

Banks and certain financial institutions are excluded from the scope of the new thin capitalization rules. In addition, related-party debts incurred within the course of cash-pooling arrangements or asset-financing transactions involving leases or "credit bail" contracts may not be considered for computation purposes, for the purpose of those activities only.

M&A Context Limitation

As part of the 4th Finance Amendment Bill for 2011, an anti-abuse rule was introduced under §209 IX F.T.C., whereby interest charges incurred in connection with the acquisition of substantial shareholdings in a French subsidiary may be disallowed unless the French acquiring company (or a French permanent establishment of a foreign company) justifies that the following cumulative conditions are met:

- "Decisions related" to the stock of the newly acquired French company are effectively taken in France, by the acquiring company itself or by a parent or a sister company established in France only; and
- Where the French acquiring company actually exercises "control or influence," it is effectively exercised in France by the same entities.

The two conditions above must be met either with respect to the shareholding acquisition fiscal year or with respect to the fiscal years relating to the 12-month period following the shareholding acquisition. If the company is not in a position to perform the required demonstration, interest charges must be recaptured until the end of the eighth year following the shareholding acquisition.

This legislation aims at preventing foreign-based groups from using a French holding company to take advantage of the French consolidation regime in claiming a deduction of the interest on the acquisition debt against profits of the French targets. Originally, the bill aimed only at French targets, but for anti-discrimination purposes, the scope was expanded to include non-French targets.

"Interest charges incurred in connection with the acquisition of substantial shareholdings in a French subsidiary may be disallowed."

The safe harbor for decision-making processes within French-only parents or Affiliates proves discriminatory vis-à-vis foreign-based groups and may be challenged on the basis of E.U. law (on the claim that it is an obstacle to the freedom of establishment) and treaty law (where the treaty includes an article preventing discrimination towards subsidiaries of parent companies established in the country of the treaty partner, comparable with Article 24.5 of the O.E.C.D. model tax treaty).

The limitation does not apply where (i) the fair market value of the acquired shares does not exceed €1 million; (ii) the acquisition is not financed, directly or indirectly, through debt; or (iii) the consolidated debt-to-equity ratio of the group is greater than or equal to the debt-to-equity ratio of the French acquiring company.

General Limitation on Interest Deductibility / Tax Barrier

As of January 1, 2014, only 75% of net financial expenses are deductible if the amount exceeds €3 million; where the amount of tax-deductible financial expenses (after the application of the interest tax deductibility limitation rules described above) less the amount of the financial profits received equals €3 million or more, 25% of the net amount is non-tax deductible. The limitation applies also to third-party debt.

Withholding Tax on Interest – Exemptions

According to §§119 *bis* 1 and 125 A III of the F.T.C., a withholding tax is in principle levied on interest paid to a nonresident recipient. However, French domestic tax law provides for several exemptions, resulting in the almost systematic exemption of withholding tax. We have outlined three of these exemptions, for (i) interest on loans (ii) interest on bonds, and (iii) interest paid inside the E.U.

In addition, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company. Thus, each of the income tax treaties between France and Germany, Austria, the U.K., Ireland, and Sweden provides for zero withholding tax on interest.

Interest on Loans

For loans contracted on or after March 1, 2010, no withholding tax applies to interest paid by a French company to a nonresident company.

Yet, a 75% withholding tax is still applicable where the interest is paid on an account held in an N.C.C.T. (as previously mentioned), unless the debtor justifies that the operations that gave rise to the interest do not principally aim or result in shifting profits to the N.C.C.T.

For loans contracted before March 1, 2010, interest can be paid free of withholding tax where:

- The initial lender is a nonresident individual or legal entity established outside of France;
- The loan is documented by an agreement executed before the loan proceeds are transferred to the French company; and
- The loan agreement sets forth the principal, the date of repayment, the interest rate, and any additional remuneration to the lender.

The subsequent sale or assignment of the receivable should not jeopardize the application of the exemption.

Interest on Bonds

Under §§119 *bis* 1 of the F.T.C., interest paid to nonresidents on bonds from French issuers is exempt from withholding tax provided that the securities were issued after January 1, 1987. Under §125 A III of the F.T.C., the levy at source is not applicable to interest on bonds ("obligations") issued after October 1, 1984 that are paid by a debtor domiciled or established in France, if the beneficial owner of the interest demonstrates that he/she has a fiscal domicile or corporate seat outside the territory of the French Republic, Monaco, or a member state of the so-called "*Zone Franc*." Evidence of the foreign domicile or seat of the beneficial owner must be furnished to the paying agent of the interest. Evidence of the foreign domicile is assumed for bonds converted into euros on or after January 1, 1999. The exemption applies to tradable securities and units in French securitization vehicles ("*Fonds Commun de Créances*").

Interest Paid to a Related E.U. Company

The recipient is an eligible E.U. company that is subject to C.I.T. in its jurisdiction of residence. The "payor" and the "beneficial owner" must be related parties. Parties will be treated as related where (i) the payor or the beneficial owner directly owns at least 25% of the capital of the other party or (ii) a third E.U. company directly holds at least 25% of the capital of both the payor and the beneficial owner. The ownership interest must be held for at least two years. Payments made before the expiration of such two-year period can be exempted from withholding tax if the shareholder undertakes to hold the ownership interest for at least two years. An E.U. permanent establishment of an eligible E.U. company can be treated as an eligible party (either as the payor or beneficial owner) as long as the interest is subject to C.I.T. in the E.U. Member State where the permanent establishment is constituted. The beneficial owner of the payments must give to the payor all the required evidence that the tests have been fulfilled.

The exemption includes an anti-abuse provision under which the exemption may be denied where the beneficial owner is controlled directly or indirectly by a non-E.U. corporate shareholder and obtaining the tax benefit is a principal reason for the structure.[23] A decree should clarify the situations covered by the anti-abuse rule. However, where an income tax treaty entered into by France with the jurisdiction

[23] See **E.U. Directive Exemption** of this article above, for E.U. dividends.

of residence of the controlling shareholder provides for a zero withholding tax on interest, the anti-abuse provision may be of little practical importance. The U.S. is one such example.

C.F.C. Legislation

Section 209 B is the French counterpart of "Subpart F" of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d'Etat*, struck down §209 B as discriminatory under the French-Swiss Tax Treaty.[24] The *Conseil* found that §209 B indeed amounted to a tax on French business profits of the foreign company, which, in the absence of a permanent establishment in France, was precluded by the France-Switzerland Income Tax Treaty applicable at that time. In addition, §209 B was clearly at odds with the principle of free establishment protected by the E.C. Treaty. The French C.F.C. rules were therefore revisited and reformed.

The law changed effective January 1, 2006. The C.F.C. rules apply both to foreign enterprises (namely permanent establishments) and to foreign entities. The foreign entities should be "established or formed" in a foreign country. They include legal entities whether or not distinct from their shareholders (*viz.*, companies, partnerships, associations, etc.). They also include trusts.

The holding threshold increased from 10% to "more than 50%" for the foreign entity to be treated as a C.F.C. under §209 B. However, that threshold drops to 5% if 50% of the legal entity is held directly or indirectly by other "French enterprises" that control or are under the control of the first French company.[25] In the case of related enterprises, the 5% test applies even if the related enterprise is not established in France.

The new provisions do not replace the current anti-abuse provision, pursuant to which an interest held by "sister entities" (whether French or foreign) is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is subject to C.I.T. at a rate below 16.66% (*i.e.*, 50% of the French C.I.T.).

Section 209 B provides an E.U. exclusion. The C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a "wholly artificial arrangement, set up to circumvent France tax legislation." This provision follows the case law developed by the European Court of Justice ("E.C.J."), particularly *Cadbury Schweppes*.[26] In the *Cadbury Schweppes* case, the E.C.J. decided that the C.F.C. was not artificially established when it participated in economic activity in the host country with the required substance (offic-

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24 CE, June 28, 2002, *Ministre de l'Economie, des Finances et de l'Industrie c/ Sté Schneider Electric,* n°232276, RJF 10/02, n° 1080.

25 Control means (i) holding directly or indirectly the majority of the share capital of the "controlled" entity, (ii) having the majority of voting rights, directly or indirectly, or (iii) having the power of decision. In addition, the control test is met where a company is *de facto* dependent on the other one, due, for example, to commercial ties.

26 E.C.J., September 12, 2006, *Cadbury Schweppes*, C-196/04 and among others: E.C.J., July 16, 1998, Imperial Chemical Industries plc, C-264/96, and guidelines issued by the F.T.A. dated January 16, 2007 (4-H-1-07).

es, etc.) and that the subjective intent of the establishment (*i.e.*, as tax planning) was not material.

A second exclusion (the "Trade or Business Exclusion") may apply to C.F.C.'s established in non-E.U. countries.

"The C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a 'wholly artificial arrangement, set up to circumvent France tax legislation.'"

Where the C.F.C. derives passive income from financial activities or the management of intangibles, the exclusion applies unless (i) the passive income comprises more than 20% of the profits of the C.F.C. or (ii) more than 50% of the profits of the C.F.C. are derived from financial activities, management of intangibles, and services rendered to affiliates. In such a case, the French taxpayer must demonstrate that using the foreign entity or enterprise does not primarily result in locating profits in a low tax jurisdiction.

From March 1, 2010, where the C.F.C. is established in an N.C.C.T., the trade and business exclusion does not apply unless the taxpayer can justify the effectiveness of the business carried out and compliance with the 20% and 50% ratios.

If the C.F.C. does not qualify for either the E.U. or the Trade or Business Exclusions, the French taxpayer may still prove that the establishment of the C.F.C. does not primarily result in locating profits in low tax jurisdictions in order to avoid the taxation of the C.F.C.'s profits in France.

In response to a 2002 decision by the *Conseil d'Etat*, a new law provides that profits derived from the legal entity established or formed abroad and attributed to the French company by virtue of §209 B would be treated as "deemed distributions." The F.T.A. contends that under these conditions conflict with the tax treaties would be eliminated.

N.O.L.'s of the French company are available to reduce the taxable income arising from the attribution of profits from a C.F.C. Moreover, tax credits of the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

Transfer Pricing

The arm's length principle applies to transactions between related parties. France follows the O.E.C.D. guidelines.

Transfer pricing documentation is mandatory in France for (i) French companies with a gross annual turnover or gross assets equal to or exceeding €400 million; (ii) French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €400 million criteria; (iii) French parent companies that directly or indirectly own at least 50% of companies meeting the €400 million criteria; or (iv) worldwide consolidated (without any financial threshold) or tax consolidated French companies (with at least one tax consolidated entity meeting the €400 million criteria within the perimeter).

The documentation – corresponding to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European commission – must include (i) general information about the group and its subsidiaries, known as the "master file," and

(ii) detailed information on the French audited company (*i.e.*, a description of its activities and transactions, including a presentation of the applied transfer pricing method), known as the "country-specific file." This documentation must be presented to the F.T.A. when the company is audited.

If the company fails to provide the documentation, a fine amounting to the greater of €10,000 or 5% of the adjusted profits[27] may apply. For tax audits realized on or after January 1, 2015, the fine may be as much as 0.5% of the amount of the transactions for which no documentation has been presented.

Since 2014, the same companies must now also annually file a simplified transfer pricing form within the six-month period following the filing of their tax return. Where transactions carried over from affiliated companies involve an amount below €100,000 per type of transaction, the company does not have to file the simplified transfer pricing documentation.

For companies not subject to the mandatory transfer pricing documentation, the F.T.A. may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company, and details regarding the activities of the nonresident affiliated companies and the tax regime applicable to them.

In order to avoid uncertainty, taxpayers may want to reach an advance transfer pricing agreement with the French tax authorities. The advance pricing agreement could be unilateral, bilateral, or multilateral. The French program proves to be efficient and pragmatic.

"Financial Transaction Tax... applies to acquisitions of listed stock issued by companies whose legal seat is in France with a market capitalization above €1 billion."

Financial Transaction Tax ("F.T.T.")

Introduced by the former French president Nicolas Sarkozy as a push toward an E.U.-wide tax (which is still being discussed), the F.T.T. imposes participation by the financial industry in the restoration of public accounts. This 0.1% tax applies to acquisitions of listed stock issued by companies whose legal seat is in France with a market capitalization above €1 billion on January 1 of the year during which the acquisition takes place.[28]

Taxable transactions involve French-issued equity securities, as defined above, and securities that may give rise to equity rights (for example, preferred stocks, convertible bonds, and any other bonds that may give rise to equity rights).

Acquisitions of options and futures are not taxable. With tax being due at the time the stock is delivered at maturity (if not issued by the company), double taxation may arise.

The F.T.T. also applies to instruments equivalent to French-listed stock or stock rights even if issued by another issuer under a foreign law (*e.g.*, American depository receipts).

The term "acquisition" includes a transfer of ownership through a purchase, exchange, contribution, or exercise of an option or through a futures contract.

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[27] The actual rate will depend on the behavior of the company.

[28] This could affect about 100 French companies.

To be subject to the F.T.T., the stock or equivalent instruments would be negotiable on a regulated market in France, the E.E.A., or on some limited non-E.U. regulated markets, such as in Switzerland (Bourse Suisse) and Montreal (Bourse de Montreal Inc.). The N.Y.S.E. is not included. Stocks listed on a multilateral trading system are also outside the scope of the tax.

Transfer Taxes

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares:

- As of August 1, 2012, a fixed tax rate of 0.1% applies to transfers of stocks issued by a French S.A., S.C.A. or S.A.S. – except if they qualify as real estate holding companies for tax purposes (intra-group transactions can benefit from a transfer tax exemption).
- Transfers of units issued by French partnerships, the capital of which is not divided into stocks – except if the entities qualify as real estate holding companies for tax purposes – are subject to a fixed transfer tax rate of 3%. A relief equal to €23,000 divided by the total number of units issued by the entity is applied to the taxable value of each unit.
- Transfers of shares issued by French real estate holding companies – irrespective of their legal form – are subject to a 5% transfer tax.
- Transfers of shares issued by foreign-deemed-French real estate holding companies are also subject to a 5% transfer tax. In addition, the transfer should be documented and executed by and before a French notary, unless the documentation is executed in France by the parties or their representatives.

Regarding the sale of assets, the following rates generally apply:

- 5.09% for transfers of real-property assets located in France (in some cases, such transfers may be subject to V.A.T. instead); and
- A progressive tax rate for transfers of business as going-concerns ("Fonds de Commerce") or goodwill: (i) 0% for the fraction of the transfer price below €23,000, (ii) 3% for the fraction between €23,000 and €200,000, and (iii) 5% for the fraction exceeding €200,000.

B.E.P.S. and France

France is one of the founding members of the Organisation for Economic Co-operation and Development ("O.E.C.D.") and is highly involved in the O.E.C.D.'s work relating to base erosion and profit shifting (the "B.E.P.S. Project"). Soon after the publication of the O.E.C.D. report "Addressing base erosion and profit shifting," in February 2013, the Parliament Commission of Finances released a report on the same topic, which reaffirmed prevention of tax evasion and tax fraud as a priority for the French government and formally endorsed the B.E.P.S. Project. The French government itself also actively encourages the European Union to act on these issues.

A report relating to the taxation of the digital economy, ordered by the French Ministry of Economy and Finance, was published in January 2013. In a related press

release, the French government stated its intention to take more decisive action in the G-20, the O.E.C.D., and the E.U., in order to adapt international tax rules to the reality of the digital economy and, in particular, to seek a more efficient definition of "permanent establishment." The report especially raised the possibility of tax on the digital economy in relation to personal data. The French government hopes that this proposition will be further analyzed.

"The French government places a higher priority on the elimination of inappropriate double non-taxation, the reinforcement and effectiveness of anti-avoidance rules, and addressing profit shifting issues."

In particular, the French government places a higher priority on the elimination of inappropriate double non-taxation, the reinforcement and effectiveness of anti-avoidance rules, and addressing profit shifting issues that arises in the context of the digital economy. B.E.P.S. issues are regularly debated in commissions and assemblies of the French parliament, and several legal provisions have been introduced in recent finance bills. For example, the 2013-2015 finance bills included provisions relating to:

- The obligation of tax professionals to disclose tax optimization schemes to the F.T.A.;
- The modification of the abuse-of-law provisions from an *exclusively* tax-driven test to a *principally* tax-driven test;
- The application of a penalty for tax professionals who advise the use of abusive tax schemes; and
- The limitation of the D.R.D. regime to dividends issued from profits resulting only from activities subject to C.I.T.[29]

The French Constitutional Court dismissed these provisions, as they do not in conform with the French Constitution on various grounds. However, other provisions have been successfully enacted, including:

- The limitation of the D.R.D. regime to dividends that have been deducted for the determination of the distributing company's taxable result (transposition of the E.U. Directive 2014/86/UE of July 8, 2014); and
- The anti-hybrid mechanism, which disallows interest in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax which would have been due in France.[30]

Certainly, the French government is highly involved in the B.E.P.S. Project at the level of the O.E.C.D., as well as at the level of the E.U., and it is expected to be a pioneer in implementing new regulations that may be proposed to combat B.E.P.S. within either organization, or at a federal level.

On the ground, experience shows that tax auditors do not hesitate to retain positions inspired by the current work of the O.E.C.D. on B.E.P.S., even if it is not compliant with the current tax law.

In light of the above, it appears that France has already started the process of adopting some anti-B.E.P.S. measures unilaterally. Such action gives rise to questions of potential double taxation unless a multilateral policy is adopted.

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[29] See **Participation Exemption or the Dividends Received Deduction** above.

[30] See **Deductibility of Interest Charges** above.

ITALY

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CORPORATE TAX RATE

As with any Italian resident company, an Italian resident holding company is subject to corporate income tax ("I.R.E.S.") levied on the worldwide income of the company at a flat rate of 27.5%, as provided in the Income Tax Code ("I.T.C.").[1]

A regional tax on productive activities ("I.R.A.P.") also applies to the net value of production performed in Italy. This tax is imposed at the general rate of 3.90%.[2] Higher rates are applicable to banks and other financial institutions (4.65%) and to insurance companies (5.90%). In addition, different regions of Italy may provide for a 0.92% variation of the above-mentioned rates.[3]

It should be noted that a holding company that is legally classified as an Italian fixed capital investment company ("*Società di Investimento a Capitale Fisso" or "S.I.C.A.F.*") is subject to the tax regime applicable to undertakings for collective investment.[4]

DIVIDEND EXEMPTION

Domestic Dividends

In general, the I.T.C. provides for a 95% exemption with regard to dividend distributions received from a domestic Italian company, whereby no withholding tax is imposed and the effective tax rate is 1.375% (0.05 x 0.275 = 0.01375).[5] There are no minimum ownership or holding period requirements.

For companies adopting I.A.S./I.F.R.S. accounting, profits received from shares or other financial assets qualifying as "held for trading" are fully taxable.[6] It is also worth noting that these companies must determine the positive and negative components of their tax base according to I.A.S./I.F.R.S. criteria, as, in principle, the accounting standards prevail over the ordinary I.T.C. rules.

Foreign Dividends

According to Article 89(3) I.T.C., the 95% exemption is also applicable to foreign-source dividends provided that the payment is not deductible by the payer in

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1 Presidential Decree dated December 22, 1986, n. 917.

2 Legislative Decree dated December 15, 1997, n. 446.

3 See Article 16 of Legislative Decree n. 446 of December 15, 1997 as amended by Law Decree n. 66 of April 24, 2014, converted into Law n. 89 of June 23, 2014.

4 Additional discussion can be found at the end of this article.

5 See Article 89(2), I.T.C.

6 See Article 89(2-*bis*), I.T.C.

its country of residence. (Non-deductibility must be stated by the foreign company in a declaration or must result from other objective evidence.)

If dividends are directly or indirectly distributed by a company resident in a "Black List" country or territory (characterized as a privileged tax regime for C.F.C. purposes), the exemption does not apply and dividends are fully taxed, unless a favorable ruling is obtained from the Italian tax authorities.

Dividends corresponding to profits already taxed in the hands of an Italian resident controlling company under the C.F.C. rules are not taxed again upon actual receipt (see also **C.F.C. Legislation** below).

"A 95% exemption regime for gains derived from the sale of shares of a subsidiary."

PARTICIPATION EXEMPTION FOR GAINS

The I.T.C. provides for a 95% exemption regime for gains derived from the sale of shares of a subsidiary. According to Article 87 I.T.C., the exemption applies to the disposal of participations in both Italian and foreign subsidiaries.

- Several conditions must be met to qualify for the exemption:
- Shares in the subsidiary must have been held for an uninterrupted period of 12 months prior to disposal. In measuring the holding period of shares acquired over time, a "Last-In, First-Out" rule applies; direct tracing is not permitted;
- The participation must be classified as a fixed financial asset on the shareholder's first balance sheet reflecting the beginning of the holding period for the shares;
- In the three fiscal years preceding the disposal of the participation, the subsidiary must be tax resident in Italy or in a jurisdiction that is not a Black List country or territory.[7] If the company is resident in a Black List jurisdiction but it was formed for the purpose of carrying out active business operations, the shareholder may request a ruling from the Italian tax authorities verifying that the purpose of the investment was not to obtain the benefits of a preferential tax regime; and
- The subsidiary must have been engaged in an active business since the beginning of the third financial year preceding the sale of the participation (unless its shares are traded on a stock exchange).

Several conditions apply to the foregoing tests. Under the anti-avoidance rules, a company is deemed not to be carrying out an active business if the predominant asset is real estate, as reported on a company's balance sheet. Where a subsidiary is a holding company, the law requires that tests regarding tax residence and business activity be applied at the level of the subsidiary operating companies. Where the participation exemption applies to a gain, only a portion of costs related to the sale is deductible, equal to the percentage of the gain that is taxable, *viz.*, 5%.[8]

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[7] See also **New White List of Countries and Territories** in this article.

[8] See Article 86(2), I.T.C.

INTEREST DEDUCTION

Finance Act 2008 has completely redefined the interest deduction regime for companies subject to I.R.E.S.

The new regime, in general, provides as follows:[9]

- Interest expense is fully deductible in each tax period for an amount equal to interest income;
- The excess amount of interest expense can be deducted subject to a cap of 30% of an amount substantially corresponding to earnings before interest, taxes, depreciation, and amortization ("E.B.I.T.D.A."), as measured in the borrower's profit and loss statement;
- The amount of interest expense that exceeds the 30% limit is, therefore, not deductible in the tax period incurred but may be carried forward indefinitely until it can be absorbed in a year when sufficient E.B.I.T.D.A. exists; and
- The excess E.B.I.T.D.A. generated in each fiscal year may be carried forward and used to increase the E.B.I.T.D.A. of the following periods.

While banks and insurance companies, as well as their holding companies and certain other financial institutions, are excluded from the interest deduction regime, it does apply to so-called "industrial holding companies," *i.e.*, companies whose main business consists of holding participations in other entities rather than lending activities or the provision of financial services.[10] Industrial holding companies are likely to be penalized by these provisions. Although, if they participate in domestic consolidation rules (see **Group Consolidation** below), the excess interest expense of the holding company can be used to reduce the consolidated tax base generated by other associated companies, if and to the extent that such other group companies report E.B.I.T.D.A. not used to support their own deductions. This rule also applies in the case of interest expense carried forward by a company, provided it has been generated during the period of fiscal consolidation. Note that in some circumstances the E.B.I.T.D.A. generated by certain nonresident controlled subsidiaries may be taken into account even though foreign subsidiaries are not permitted in an Italian domestic consolidation.

Specific rules apply to banks and insurance companies.

MINIMUM TAXABLE INCOME FOR NON-OPERATING COMPANIES

Specific anti-avoidance rules apply to non-operating companies and non-operating permanent establishments in Italy. Under Article 30 of the Law dated December 23, 1994, n. 724, an entity is deemed to be a non-operating company when the sum of its turnover, increase in inventory, and revenue (as reported on its profit and loss statement) is lower than a specified base.

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[9] See new Article 96, I.T.C.

[10] See Article 96(5), I.T.C.

The base is the sum of the following items: (i) 2% of the total value of participations in resident and nonresident companies, bonds, other financial instruments, and financial credits; (ii) 4%-6% of the value of real estate and ships owned or leased by the company; and (iii) 15% of the value of other fixed assets. The calculation is made on the average values over a three-year period (*i.e.*, the tax period concerned and the two preceding periods).

When a company is a non-operating company under the foregoing definition, it is taxed at a 38% rate on minimum income, calculated by applying a deemed return to the assets mentioned above. The deemed returns are (i) 1.50% of participations, other financial instruments, and financial credits; (ii) 4.75% of real estate values (reduced to a 3%-4% rate for residential real estate assets and offices); and (iii) 12% of other fixed assets.

A non-operating company may attempt to demonstrate to the Italian tax authorities that specific facts and circumstances prevented it from achieving the minimum turnover and thereby receive a ruling to qualify for the exception. There are also certain automatic exclusions from the scope of the general rule. Finance Act 2008 has increased the number of these exclusions, notably for (i) companies in the first year of activity; (ii) companies whose shares are traded on a stock exchange, as well as the subsidiaries and controlling shareholder of such companies; (iii) companies that have had at least ten employees in the two preceding fiscal periods; (iv) companies whose value of production, as measured on the profit and loss statement, is greater than the total value of assets reported on the balance sheet; (v) companies holding participations in subsidiaries that are considered to be "operating" companies or that have obtained a positive ruling; and (vi) companies in insolvency proceedings.

"When a company is a non-operating company...it is taxed at a 38% rate on minimum income."

Subsequent to the amendments made by Article 2 of Law Decree n. 138 of August 13, 2011, the foregoing provisions are also applicable to companies that have (i) incurred fiscal losses for at least five consecutive tax years or (ii) incurred fiscal losses for four out of the five years of assessment and in one year have reported income that is lower than the minimum income, as determined in the manner described above. Beginning in the sixth consecutive tax year, those companies will be deemed to be non-operating companies even though they do not meet the usual requirements provided by Article 30(1) of the Law dated December 23, 1994, n. 724.

ALLOWANCE FOR CORPORATE EQUITY ("A.C.E.")

In order to encourage companies to strengthen their financial structures by using equity rather than debt, Article 1 of Law Decree n. 201 of December 6, 2011 introduced the Allowance for Corporate Equity ("A.C.E."), whereby a notional return on the increase in equity generated after 2010 may be deducted from total net income, if it is derived from capital contributions and the retention of earnings. The amount of A.C.E. that exceeds the net taxable income of the year can be carried forward and used to offset the net taxable base of a subsequent tax period, or – starting from 2014 – it can be converted into a tax credit equal to 27.5% of the notional yield to offset (in five equal annual installments) the I.R.A.P. due for each tax year. Ministerial Decree of March 14, 2012 (hereinafter "the Decree") contains the operative provisions of this rule.

"A notional return on the increase in equity generated after 2010 may be deducted..."

The A.C.E. provision is effective from the tax year in which December 31, 2011 falls. The benefit may be claimed by:

- Companies resident in Italy, as indicated by Article 73(1)(a) I.T.C.;
- State and private entities other than companies, as well as trusts resident in Italy, whose main or exclusive objective is to carry out a commercial activity, as indicated by Article 73(1)(b) I.T.C.;
- Italian permanent establishments of nonresident companies and entities, as indicated by Article 73(1)(d) I.T.C.; and
- Individuals, S.N.C.'s, and S.A.'s regulated by ordinary accounting rules.

A.C.E. is determined by applying a given percentage rate to the net increase in equity, which in turn is calculated as the excess of the equity book value at the end of the year over the equity book value resulting from the balance sheet as of December 31, 2010. The increase in equity book value attributable to the increase in retained earnings for the year is not taken into account.[11]

In order to determine the net increase in equity, Article 5(2) of the Decree states that the following items must be taken into account:

- Cash contributions paid by existing or new shareholders;
- The shareholders' unconditional relinquishment of an obligation of the company and the release of an obligation upon the underwriting of a new issue of shares; and
- Income accumulated, with the exception of income accumulated in non-available reserves.[12]

The net increase in any particular year cannot exceed the value of the net equity at the end of that year.[13]

In computing the net increase in equity, Article 5(3) of the Decree provides that decreases in equity through any type of distribution to a shareholder must be taken into account (for instance, through dividend distributions or equity reductions).

Once the increase is computed, Article 3 of the Decree provides that, for the tax year in which December 31, 2011 falls and the following two tax years (2012 and 2013), a deduction is allowed for 3% of the increase. With reference to the tax years 2014, 2015, and 2016, the deduction is 4%, 4.5%, and 4.75%, respectively.[14] In subsequent tax years, the percentage will be determined by a decree of the Minister of Economy and Finance issued by January 31 following the close of the tax year.

In August 2014, Law n. 116/2014 introduced a new tax incentive aimed at encouraging Italian companies to go public by strengthening A.C.E. In particular, new listed

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[11] See Article 2 of the Decree.

[12] See Article 5(5) for the definition of "non-available reserves."

[13] See Article 11 of the Decree.

[14] See the Article 1 of Law Decree n. 201 of December 6, 2011, as modified by the Article 1(137) of the Law n. 147 of December 27, 2013.

companies would benefit from a 40% increase on new equity raised during the first three years of admission to the regulated markets or E.U./E.E.A. multilateral trading platforms ("super-A.C.E.").[15]

Specific rules are provided for companies participating in a group consolidation[16] and for companies opting for the "transparency regime" under Articles 115 and 116 I.T.C.[17]

Article 10(3) of the Decree provides specific anti-avoidance rules, especially for companies belonging to a group.

GROUP CONSOLIDATION

After the introduction of the participation exemption regime, holding companies cannot reduce income through unrealized losses in participations. However, group consolidation is permitted.[18] Two consolidation regimes exist. One is known as the domestic consolidation regime; the other is the international or worldwide consolidation regime.

Domestic Consolidation

For the purposes of the domestic consolidation regime, a group of companies is comprised of a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two factors exist. First, the common parent must directly or indirectly have the majority of voting rights at the subsidiary's general shareholders' meeting. Second, the common parent must directly or indirectly hold more than 50% of the subsidiary's shares and be entitled to more than 50% of the subsidiary's profits.

Under limited circumstances, a nonresident company may participate in a domestic consolidation as the common parent of the group. First, the foreign parent must be a resident in a country that has a tax treaty in effect with Italy. Second, it must carry out business activities in Italy through a permanent establishment, and the participations in the controlled subsidiaries must be recorded on the books of the permanent establishment.

The domestic consolidation regime only applies when an election has been made by the common parent and the participating controlled subsidiaries; all subsidiaries are not required to participate in the regime. Once an election is made, the domestic consolidation is effective for three tax periods. If the requisite degree of control in a subsidiary is relinquished during this time, that subsidiary no longer participates.

The domestic consolidation regime works as follows. Each company determines its taxable income or loss on an individual basis, according to the ordinary rules, and submits its own tax return (without computing the relative income tax or credit). Then, the common parent aggregates the group's taxable income or loss and computes the consolidated income tax or credit. The total taxable income or loss of

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[15] This measure is still subject to E.U. Commission approval.

[16] See Article 6 of the Decree.

[17] See Article 7 of the Decree.

[18] See Article 117-129, I.T.C.

each controlled subsidiary is taken into account, regardless of the percentage held by the common parent.

Domestic consolidated groups may take advantage of a rule that allows for a combined computation of E.B.I.T.D.A. and interest expense. In addition, the E.B.I.T.D.A. of certain controlled foreign subsidiaries may be taken into account in computing the consolidated ceiling, even though foreign subsidiaries are excluded from the domestic fiscal consolidation (see **Interest Deduction** above).

A separate limitation rule applies to losses incurred during a tax period in which a company did not participate in the consolidation regime. These losses are ring-fenced in that company and cannot be brought forward to reduce group income.

Worldwide Consolidation

In addition to the domestic regime, Italian law allows for worldwide consolidation where an Italian resident company controls one or more nonresident companies.[19] In order for a nonresident company to participate, its financial statements must be audited and an advance approval must be obtained from the Italian tax authorities.

Several differences exist between the domestic consolidation regime and the worldwide regime. First, the worldwide regime is not selective among group members. The option must be exercised by *all* of the nonresident controlled subsidiaries. Furthermore, the first election for worldwide consolidation is effective for five tax periods, and any subsequent renewal is effective for three tax periods. It is believed that the option for worldwide consolidation has been exercised only by a few Italian groups of companies.

C.F.C. LEGISLATION

Italian tax law contains a C.F.C. regime applicable to individuals and companies that control, directly or indirectly, companies or other entities resident in jurisdictions characterized by a privileged tax regime.[20] These countries and territories have been identified according to certain factors, most importantly a noticeably lower level of taxation compared to the Italian tax burden and the absence of an adequate procedure for the exchange of information. Pursuant to Law n. 190 of December 23, 2014, a low-tax jurisdiction, for C.F.C. purposes, is defined as a jurisdiction whose level of taxation is lower than 50% of the Italian rate. Countries with privileged tax systems are listed in the Ministerial Decree dated November 21, 2001 (the so-called "Black List"), as modified by the Ministerial Decree of March 30, 2015. Plans to substitute the Black List with a "White List" can be found in Finance Act 2008 (as discussed in the following section).

For purposes of the C.F.C. regime, control is defined according to the Italian Civil Code.[21] A company may be deemed to be controlled in one of three circumstances:

- The Italian resident holds, directly or indirectly, the majority of the voting rights exercised at the general shareholders' meeting of the company;

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[19] See Articles 130-142, I.T.C.

[20] See Article 167, I.T.C.

[21] See Article 2359 of the Civil Code.

- The Italian resident holds, directly or indirectly, sufficient votes to exert a decisive influence in the shareholders' meeting of the company; or
- The Italian resident exercises a dominant influence over the company by virtue of contractual relationships.

In order to avoid the application of the C.F.C. regime, an Italian resident company may request a ruling from the Italian tax authorities and provide evidence that (i) the nonresident company carries out an effective industrial or commercial business activity in the market/territory of the country where it is located or that (ii) the Italian company does not benefit from a diversion of income into a privileged tax regime. Concerning the first of the foregoing two conditions, the Law Decree n. 78/2009 introduced the following changes:

- With respect to banking, financial, and insurance activities, the condition is deemed to be met when the main portion of the respective sources, investments, and proceeds originate in the state or territory where the foreign company is located; and
- The condition is never met when more than 50% of the foreign company's proceeds are derived from (i) the management, holding, or investment in securities, shares, receivables, or other financial assets; (ii) the transfer of or license to use intangible rights of industrial, literary, or artistic property; or (iii) the supply of services, including the financial ones, within the group.[22]

Law Decree n. 78/2009 has also broadened the scope of the C.F.C. rules to include controlled companies not resident in Black List jurisdictions if the following conditions are both met:

- The C.F.C. is subject to actual taxation that is less than 50% of the tax that would have been levied if it were resident in Italy; and
- More than 50% of the profits of the C.F.C. are derived from the management, holding, or investment in securities, shares, receivables, or other financial assets, from the disposal or licensing of intellectual property rights, or from the performance of intra-group services.[23]

A safe harbor clause provides that the C.F.C. rules will not be applicable, although the company meets the conditions outlined above, if the resident shareholder can in fact demonstrate, by applying for an advance tax ruling, that the localization abroad does not constitute an artificial scheme aimed at achieving undue tax advantages.[24]

If the C.F.C. rules apply, the profits of the C.F.C. are deemed to be the profits of the Italian resident. These profits are taxed separately at the average tax rate of the Italian resident, which is 27.5% for corporations.

Italian law contains a previously taxed income concept. As a result, when profits that were previously attributed to the resident company are distributed in the form of a dividend, the dividend does not constitute taxable income upon receipt.

"Italian tax law contains a C.F.C. regime applicable to individuals and companies that control, directly or indirectly, companies or other entities resident in jurisdictions characterized by a privileged tax regime."

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[22] See Article 167(5-bis).

[23] See Article 167(8-bis).

[24] See Article 167(8-ter).

NEW WHITE LIST OF COUNTRIES AND TERRITORIES

Finance Act 2008 has replaced the Black List of jurisdictions characterized by a privileged tax regime (compiled for C.F.C. purposes) with a new White List of countries and territories, which provide for adequate exchange of information between tax authorities and a level of taxation that is not significantly lower than that in Italy. The C.F.C. rules and all other I.T.C. rules relating to the Black List (including the dividend and participation exemption regimes) have been modified to reflect this change. However, the amendment has not yet come into effect, as the new White List will be applicable only from the tax period following its date of publication. As of May 2015, the White List has not been published. For this reason, the Black List (as modified by the Ministerial Decree of March 30, 2015) should remain in force for the 2015 taxable year.

TREATY PROTECTION

Italy has tax treaties in effect with 91 jurisdictions, including certain developed countries and significant trading partners. In general, the treaties provide for reduced withholding tax rates, in line with the O.E.C.D. Model Treaty. Notable exceptions exist for withholding tax on interest. In the new treaty with the U.S., the withholding tax rate is 10%.

WITHHOLDING TAXES ON OUTBOUND PAYMENTS

Dividend Withholding – Domestic Law

In general, Italian law provides that dividends distributed by Italian companies are subject to a 20% withholding tax (26% starting from July 1, 2014, pursuant to Law Decree n. 66/2014, converted into Law n. 89 of June 23, 2014). The rate may be reduced to 11% for dividends paid out to pension funds established in E.U. Member States or E.E.S. Countries (*i.e.*, Iceland, Liechtenstein, and Norway) included on the White List. The recipient can claim a refund of up to eleven twenty-sixths of the withholding tax incurred, if taxes have been paid on the same income in its country of residence.[25] If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.

For dividends distributed to companies or other entities resident and subject to income tax in E.U. Member States or E.E.S. Countries included on the White List, a reduced 1.375% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions made to domestic companies. (See **Dividend Exemption** above.)

If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are treated as described above (subject to a 95% exemption).

Parent-Subsidiary Directive

Under the Parent-Subsidiary Directive implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may claim a refund

[25] Article 27(3) of Presidential Decree n. 600/1973.

of 20% (26% starting from July 1, 2014, pursuant to the Law Decree n. 66/2014, converted into Law n. 89 of June 23, 2014) or 1.375% withholding tax levied on dividends distributed by Italian subsidiaries. After the amendments brought by Directive 2003/123/CE,[26] the required minimum for direct shareholding in the Italian company is reduced to 10%.

In order for a company to qualify as a parent for the benefit of the Parent-Subsidiary Directive, it must meet certain requirements. First, it must have one of the corporate forms listed in the Directive. Second, it must reside for tax purposes in an E.U. Member State. For this purpose, a dual resident company is not considered to be a resident of an E.U. Member State if its residence is allocated to a jurisdiction outside the E.U. under an income tax treaty. Third, the company must be subject to one of the income tax regimes listed in the Directive without the possibility of opting for favorable regimes or exemptions. Finally, it must have held the participation for an uninterrupted period of at least one year.

To demonstrate compliance with the first three conditions, a certificate issued by a foreign tax authority must be submitted. The last condition is corroborated by a declaration. Once the foregoing conditions have been met, the exemption is mandatory.

Interest and Royalties

Italy has implemented the Interest and Royalties Directive providing for a withholding exemption on payments of interest and royalties made to associated companies resident in E.U. Member States.[27] In order to qualify for the exemption, the recipient must be an associated company resident in another Member State that (a) is subject to one of the taxes listed in Annex B to the Directive and (b) has one of the corporate forms listed in Annex A to the Directive. Alternatively, the recipient can be a permanent establishment of a company resident in a Member State, granted the permanent establishment is also situated in a Member State. Moreover, the nonresident recipient must be the beneficial owner of the payments.[28]

Two companies are deemed associated under one of two tests: (i) one of the companies holds directly at least 25% of the voting rights at the general shareholders' meeting of the other company, or (ii) a third company resident in a Member State and having one of the corporate forms listed in the annex to the Directive holds directly at least 25% of the voting rights in both companies. The requisite ownership must be held for at least one year.

Article 23(1) of Law Decree n. 98 of July 6, 2011 introduced a new 5% withholding tax applicable to interest paid to a nonresident that is not the beneficial owner of the payments, provided that (i) the aforementioned conditions (a) and (b) are met; (ii) the interest payment is intended to finance the payment of interest and other proceeds on bonds issued by the recipient; (iii) the bonds are traded on an E.U. or E.E.S. regulated market; and (iv) the bonds are guaranteed by the paying company, the holding company, or another subsidiary.[29]

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[26] Implemented in Italy by Legislative Decree dated February 6, 2007, n. 49.

[27] See Article 26-*quater*, Presidential Decree n. 600/1973.

[28] For the definition of "beneficial owner" see Article 26-*quater* (4), Presidential Decree n. 600/1973.

[29] For more details, see Article 26-*quater* (8-*bis*).

Nonresident Company with a Permanent Establishment

Companies with a permanent establishment in Italy are taxed on the income of the permanent establishment. Income of the permanent establishment is determined under the rules applicable to income of resident companies, including the Participation Exemption regime (as discussed above).

Nonresident Company – No Permanent Establishment

Nonresident companies without a permanent establishment in Italy are taxed on income generated in Italy under the rules applicable to resident individuals.[30] In particular, they are deemed not to have business income.

Where the foreign corporation sells an interest in an Italian subsidiary, the tax treatment depends on whether the participation is qualified. If the participation is qualified,[31] 49.72% of the capital gain is included in taxable income and is subject to I.R.E.S. If the participation is not qualified and the disposition relates to a participation in a listed company, capital gains are deemed to have been generated outside of Italy.[32] If the participation is not qualified and the disposition relates to a participation in a private company, capital gains are not taxed if the shareholder is resident in a country that has an agreement allowing for an adequate exchange of information with Italy.[33] Finally, if the participation is not qualified, the disposition relates to a participation in a private company, and the shareholder is resident in a country without an adequate exchange of information agreement, capital gains are subject to a 20% substitute tax (26% starting from July 1, 2014, pursuant to Law Decree n. 66/2014, converted into Law n. 89 of June 23, 2014).[34]

A participation in a listed company is deemed to be qualified if the total participation sold during a period of 12 months represents an amount that is greater than 2% of the company's voting rights or 5% of the capital of the listed company. If the company is not listed, a participation is qualified if the total participation sold during a period of 12 months represents an amount that is greater than 20% of the company's voting rights or 25% of the capital of the company.

"Where the foreign corporation sells an interest in an Italian subsidiary, the tax treatment depends on whether the participation is qualified."

These rules are subject to modification under an applicable treaty.

FOREIGN TAX CREDIT

A foreign tax credit is granted to avoid international double taxation.[35] The tax credit is calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period.[36]

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30 See Articles 151 and 152(2), I.T.C.

31 According to Article 68(3), I.T.C.

32 See Article 23(1)(f), I.T.C.

33 See Article 5(5)(a), Legislative Decree dated November 21, 1997, n. 461.

34 See Article 5(2), Legislative Decree n. 461/1997.

35 See Article 165, I.T.C.

36 See Article 165(6), I.T.C.

TRANSFER PRICING

The Italian transfer pricing regime is contained in Articles 110(7) and 9(3) I.T.C.

Pursuant to Article 110(7), business income of an Italian-resident enterprise derived from (i) transactions with a nonresident company that is directly or indirectly controlled by the Italian enterprise; (ii) operations where the foreign company controls the Italian company; or (iii) transactions between resident and nonresident companies that are under the common control of a third company, is assessed on the basis of the "normal value" of the goods transferred or received, or the services rendered or received (if an increase in taxable income is derived therefrom).

The normal value of goods and services must be determined on the basis of the rules established under Article 9(3) I.T.C.; this value is similar to the arm's length value defined by the O.E.C.D. Guidelines and the O.E.C.D. Model Convention.

Legislative Decree 78 of May 31, 2010 introduced Italian regulations for intercompany transfer pricing documentation. Although such documentation is not mandatory, this decree provides for the non-application of administrative penalties (otherwise ranging from 100% to 200% of the tax assessed), if the taxpayer provides the relevant transfer pricing documentation to the tax authorities during a tax audit.

Over the past few years, the Italian tax authorities have paid increasing attention to intra-group transactions during tax audits, and the number of audits of intra-group transactions within multinational groups has risen.

Particular attention is given to management services received by an Italian company from its foreign holding company. The deduction of intra-group management fees is subject to certain domestic rules which require specific documentation (in addition to transfer pricing documentation) demonstrating that the provision of services and the potential benefit for the recipient are real and valid.

ITALIAN MEASURES TO COMBAT B.E.P.S.

Italy is an active participant in the O.E.C.D./G-20 initiative to combat base erosion and profit shifting (the "B.E.P.S. Project").

Fifteen specific actions are being developed in the context of the B.E.P.S. Project. These actions cover, in substance, all main areas of international taxation, as they relate to C.F.C. rules, interest deductibility, artificial avoidance of P.E. status, transfer pricing rules, curbing harmful tax practices, data collection, mandatory disclosure rules, and dispute resolution.[37]

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[37] In particular, the fifteen specific actions are as follows: (Action 1) Address the tax challenges of the digital economy; (Action 2) Neutralize the effects of hybrid mismatch arrangements; (Action 3) Strengthen C.F.C. rules; (Action 4) Limit base erosion via interest deductions and other financial payments; (Action 5) Counter harmful tax practices more effectively, taking into account transparency and substance; (Action 6) Prevent treaty abuse; (Action 7) Prevent the artificial avoidance of P.E. status; (Actions 8, 9, 10) Assure that transfer pricing outcomes are in line with value creation and the actions to address it; (Action 11) Establish methodologies to collect and analyze data on B.E.P.S.; (Action 12) Require taxpayers to disclose their aggressive tax planning arrangements; (Action 13) Re-examine transfer pricing documentation; (Action 14) Make dispute resolution mechanisms more effective; and (Action 15) Develop a multilateral instrument.

Some of the Italian tax measures introduced in the past year are directly or indirectly connected with the aims of the B.E.P.S. Project, and other related measures will enter into effect shortly.

In particular, in order to promote tax transparency and disclosure initiatives (Actions 5 and 11), a voluntary disclosure procedure has been introduced in Italy. In furtherance of this procedure (and O.E.C.D. recommendations), the Italian government has recently signed agreements with Liechtenstein, Luxembourg, Munich, San Marino, Switzerland, Taiwan, and Vatican City regarding the exchange of information.

In addition, the approach suggested in the deliverable regarding Action 5 has led to a reform of the new intellectual property regime (the "patent box"), introduced in Italy in 2014, which provides tax relief for income derived from know-how, patents, and the like. In particular, Law n. 190/2014 introduced a revision of the regime ensuring that benefits are granted only to income that arises from intellectual property for which the actual research and development ("R&D") activity was undertaken by the taxpayer, which is in line with the so-called "nexus approach" recommended in Action 5 (see the explanatory document of Law n. 190/2014).

"Italy is an active participant in the O.E.C.D./G-20 initiative to combat base erosion and profit shifting."

Many other tax provisions will be enacted by the end of 2015. Pursuant to Law n. 23 of March 11, 2014, the Italian parliament has declared that it must institute tax reform related to key actions of the B.E.P.S. Project. This includes legislation addressing each of the following areas:

- Monitoring of tax evasion transactions;
- Monitoring base erosion;
- Tax avoidance arising from transactions involving an abuse of law;
- Ruling procedures related to transfer pricing;
- Tax residency;
- Controlled foreign companies;
- Repatriation of dividends from Black List countries;
- Deductions related to transactions with companies in Black List countries;
- Withholding taxes; and
- Permanent establishments.

The Italian government will gradually implement these tax reforms through various legislative decrees. Drafts of several decrees were approved by the government in April 2015 and are currently under parliamentary review.

One of these draft decrees, the "International Tax Decree," provides new tax rules that appear to be closely linked to the B.E.P.S. reports released in 2014 and 2015, such as:

- The modification of advance ruling procedures for international companies related to (i) transfer pricing operations, (ii) the existence of a permanent establishment, and (iii) the attribution of profits to a permanent establishment, in order to provide for the spontaneous exchange of information by the Italian tax authorities;

- The adoption of an "effectively connected income concept" for permanent establishments, repealing the so-called "force of attraction" rules, which currently provide for the taxation of certain income produced in Italy but not effectively linked to the permanent establishment;[38] and

- The reform of C.F.C. rules, to provide for (i) the repeal of the mandatory ruling procedure in order to obtain exemption from the application of the C.F.C. rules for foreign subsidiaries and (ii) the abolition of C.F.C. regimes for "affiliated" companies (*i.e.*, at least 20%-owned by an Italian resident, or 10%-owned if the parent company is a listed company), among other revisions.

Other tax measures provided by the International Tax Decree are intended to comply with rulings of the European Court of Justice, these include:

- The new rules regarding domestic tax consolidation, which extend the possibility to opt for the Italian consolidation regime to "sister" companies (including permanent establishments) controlled by the same foreign companies (resident in an E.U. Member State or E.E.A. country allowing adequate exchange of information);[39] and

- Revisions to the outbound transfer of tax residence regime, which (i) extend the possibility to defer exit taxation with reference to a transfer of residence out of Italy as the result of a business merger and (ii) expressly confirm application of the regime to Italian permanent establishments of foreign companies.[40]

Another draft decree, the "Certainty Decree," reviews Italy's anti-avoidance rules and anti-abuse regime. The Certainty Decree introduces a legal definition of "abuse of law" in order to improve "cooperative compliance," as suggested at the O.E.C.D. level, and to comply with the European Commission recommendation of December 6, 2012 on aggressive tax planning (2012/772/EU).[41]

TAX REGIME FOR HOLDING COMPANIES CLASSIFIED AS S.I.C.A.F.'S

According to the new definitions of Undertakings for Collective Investment ("U.C.I.'s") and Alternative Investment Fund Managers ("A.I.F.M.'s") provided by Legislative Decree n. 44/2014 (the "A.I.F.M. Decree") – which implements Directive n. 2011/61/EU on Alternative Investment Fund Managers (the "A.I.F.M. Directive") – some Italian holding companies could be deemed to be S.I.C.A.F.'s and, therefore, subject to the tax regime applicable to U.C.I.'s. It should be noted that such treatment would be an exception to the general rule, according to which holding companies do not fall within the new definitions of U.C.I. and A.I.F.M.

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38 At the same time, the International Tax Decree should introduce an optional all-in "foreign branch exemption" regime for Italian companies.

39 See E.C.J. C-39/13, C-40/13, C-41/13 of June 2014.

40 See E.C.J. C-371 of November 29, 2011 and C-38/10 of September 6, 2012.

41 See the explanatory document in the draft of the Certainty Decree.

In particular, both the A.I.F.M. Decree and the A.I.F.M. Directive provide that a holding company is outside the scope of the respective legislation, if it is a company:

> With shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies, or participations in order to contribute to their long-term value, and which is either a company: (i) operating on its own account and whose shares are admitted to trading on a regulated market in the Union; or (ii) not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents.[42]

Conversely, it seems that holding companies other than those described above could fall within the scope of the A.I.F.M. Decree and A.I.F.M. Directive and, in particular, within the definition of a S.I.C.A.F. (*i.e.*, a closed-end U.C.I. in the form of a joint stock company with fixed capital and a registered office and general management in Italy, its exclusive purpose being the collective investment of assets obtained by the offer of its own shares and other financial instruments of equity held by the same).

If a holding company is deemed to be a S.I.C.A.F., it is subject to the tax regime applicable to U.C.I.'s, which is unlike the tax regime for holding companies described above.

In principle, a U.C.I. is considered liable for tax in Italy as if it were a normal joint stock company – but it is exempt from income tax, and as a consequence, the group tax consolidation regime mentioned above is not permitted. While the S.I.C.A.F. itself is exempt from income tax, the profits arising from investments carried out by such an entity are taxed at the investors' level through the application of a withholding tax. The withholding tax rate will depend on tax residence and subjective status of the investor. Hence, certain tax regimes described above, such as the dividend exemption or the participation exemption, are not applicable.[43]

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[42] See Article 4 of the A.I.F.M. Decree and A.I.F.M. Directive.

[43] Therefore, in the absence of specific transitional rules, the transformation of a holding company (having the legal form of a corporate entity) into a S.I.C.A.F. could lead to taxation of any unrealized gains on its assets, since such an operation could be considered – from a tax point of view – to be a transformation of a corporation into a "non-commercial" entity.

GERMANY

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INTRODUCTION

In the past few years, several steps have been taken to make Germany a more attractive jurisdiction for holding companies - especially within the European Union. At the same time, efforts have been made to prevent multinational businesses from using international financing structures that treat interest paid to shareholders as business expenses in Germany while leaving the profits of business operations taxable in tax havens.

In determining Germany's advantages as an investment location, judgment should not rest solely on the tax rate: whereas the base corporate tax rate of 15% seems to be very attractive, the effective tax rate ranges at about 30%, due to the added trade tax burden. Nevertheless, preferred tax treatment for dividends received from other companies and capital gains from the sale of participations, as well as an exemption from dividend withholding tax for dividends paid to companies resident in E.U. Member States, has ultimately created a competitive tax environment for investments in Germany. This is particularly interesting, given that the German economy has not suffered from the worldwide financial crisis to the extent of other European economies, and makes Germany an attractive location for holding companies and active investments. In addition, Germany has one of the largest tax treaty networks, with only a few countries, such as Brazil and Saudi Arabia, being excluded.

GENERAL TAXATION OF GERMAN CORPORATE ENTITIES

A German holding company is subject to both corporate tax and trade tax. The regular corporate tax rate is 15% (plus a 5.5% solidarity surcharge on the corporate tax liability). In addition to the corporate tax, trade tax has to be paid by most companies. Trade tax is a municipal tax and the rate is determined by each municipality, which leads to an effective trade tax rate between 7% and 17% (with the average being 14%). Therefore, the effective tax burden for a corporate entity is about 30%. It should be mentioned that there is special trade tax treatment for pure real estate companies. Under certain circumstances, these companies are fully exempt from trade tax. This makes Germany a very attractive place for real estate holding companies no matter where in Germany the real estate is located.

The taxable base for corporate tax, solidarity surcharge, and trade tax is the income defined through the tax balance sheet, with certain adjustments for taxable income, as defined by the Trade Tax Act.

GENERAL PARTICIPATION & DIVIDEND EXEMPTION

Background

In Germany, corporate tax is levied on the profit of a corporation as computed in the company's commercial balance sheet and adjusted for tax purposes. There is no difference in the treatment of distributed or retained profits.

Dividends and capital gains received from corporations within or outside of Germany are essentially exempt from German corporate tax. However, 5% of these dividends or capital gains are treated as nondeductible expenses, resulting in an effective tax of less than 2% on these profits. To discourage the use of hybrid financing structures this beneficial treatment has recently been restricted. The dividends received are now fully taxable in cases where they are treated as a deductible expense for the subsidiary making the distribution.

The corporation is obliged to remit withholding tax on dividends paid to shareholders at a rate of 25% (plus the solidarity surcharge). This withholding tax ("*Kapitalertragsteuer*") is credited in full against the individual tax liability of the recipient. As the final tax rate on dividend income and capital rate gains for individuals is a flat tax rate (irrespective of the individual tax rate), no further tax is due. In the case of business income, 40% of the income derived from dividends and capital gains is subject to the regular tax rate resulting from the tax assessment. Again, the withholding tax will fully be credited against the respective income tax liability.

"A 95% participation exemption applies to capital gains on participations in domestic and foreign entities."

Participation Exemption

A 95% participation exemption applies to capital gains on participations in domestic and foreign entities. Neither a certain holding period, nor any minimum participation is required. It also applies for trade tax purposes. The 95% participation exemption includes profits from recaptures and hidden profit distributions upon the sale of shares below fair market value.

The participation exemption also applies to a participation held directly or indirectly through a partnership. This may be the case when (i) Corporation A disposes of a share in a partnership that owns an interest in Corporation B or (ii) a partnership disposes of a participation.[1] The participation exemption for partnership structures applies for trade tax purposes as well.

However, there are certain exceptions with regard to this tax-free treatment, most importantly as follows:

- The exemption does not apply when a tax-deductible write-down of the shares has been carried out in the past and has not been reversed by the time of sale.[2]
- The exemption does not apply to shares held by a company engaged in financial business ("*Finanzunternehmen*"), where the shares were acquired with the intent of realizing short-term profit.[3] According to the tax courts, companies mainly engaged in holding activities may fall under this provision.[4]

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[1] Sec. 8b, para. 6 C.I.T.A.

[2] Sec. 8b, para. 2, sent. 4 C.I.T.A.

[3] Sec. 8b, para. 7, sent. 2 C.I.T.A.

[4] Judgment of the Federal Tax Court dated January 14, 2009.

- A general exception from the 95% participation exemption exists for banks and financial institutions, as well as for life and health insurance companies.

Reductions in profits arising in connection with corporate stock holdings (in particular, extraordinary write-downs) are disregarded in determining taxable income. This exception also applies to shareholder debt under the following prerequisites:

- Reductions in profits in connection with a loan (*e.g.*, write-downs to going-concern value and forgiveness of the unrecoverable portion of a debt claim);
- Reductions in profits in connection with securities and guarantees given for a loan; and
- Reductions in profits resulting from legal acts that are the economic equivalent of a loan.

This provision applies to loans made or security posted by: (i) substantial shareholders (those holding more than 25% of the share capital either directly or indirectly), (ii) persons related to substantial shareholders, and (iii) third parties with a right of recourse against the aforementioned persons. The statute would apply even if the shareholder is no longer a substantial shareholder at the time of the reduction in profits, but previously held such status. The denial of a deduction does not apply if it is shown that an unrelated third party would also have made the loan under the same circumstances or would not have required its repayment (the "arm's length exception"). Only security given by the company in question (*i.e.*, the debtor) is taken into account for purposes of the arm's length exception.

"The participation exemption for dividends is applicable only where the dividend payment has not reduced the taxable income of the payor of the dividend."

Dividend Exemption

The dividend exemption applies to dividends received from both domestic and foreign participations.[5] For corporate tax purposes, the exemption does not depend on any holding period and does not require any minimum participation.

The dividend exemption applies for trade tax purposes as well, if a participation of at least 15% has been held at the beginning of the tax year. In the case of foreign dividends received, a participation of at least 15% has to be held for an uninterrupted period from the beginning of the tax year and the foreign company has to pass an activity test. For participations in E.U. subsidiaries, a participation of 10% qualifies for the dividend exemption and no activity test is required.

Similar to the 95% participation exemption, the dividend exemption is limited to 95% of the dividends received, as 5% of all dividends received are deemed to be non-deductible expenses. In principle, this applies regardless of the amount of effective business expenses related to the dividend. As an advanced measure related to the changes to Article 4 the E.U. Parent-Subsidiary Directive and the O.E.C.D.'s B.E.P.S. Project, German tax law has been amended to provide that the participation exemption for dividends is applicable only where the dividend payment has not reduced the taxable income of the payor of the dividend.[6]

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[5] Sec. 8b, para. 1 C.I.T.A.

[6] Sec. 8b para. 1 s. 1 C.I.T.A.

Financing Expenses

Despite the capital gains and dividend exemption, financing costs related to the acquisition of shares are, in principle, fully deductible for corporate tax purposes, within the limitations of the earning stripping rules (which are discussed later in this article). This is an exception to the general rule of German tax law, which provides that business expenses incurred in relation to tax-exempt income (*i.e.*, dividends or capital gains) are not tax deductible.[7] A different rule is applicable for trade tax purposes. When computing trade tax income, 25% of the interest on debt is added back to the tax base.

TRADE TAX ADD-BACKS AND DEDUCTIONS

The income computed for corporate tax purposes is adjusted for trade tax purposes by various add-backs and deductions.

Add-backs include one-fourth of the sum (exceeding €100,000) of the following:

- Loan remuneration (*e.g.*, interest);
- Recurring payments;
- Profit shares of a silent partner;
- 20% of rental and leasing payments for moveable fixed assets;
- 65% of rental and leasing payments for immoveable fixed assets;
- 25% of payments to obtain license rights for a limited time period, except for licenses that merely confer entitlement to license to third parties the rights derived there under.

The additional deductions include:

- 1.2% of 140% of the assessed value ("*Einheitswert*") of real property;
- The distributive share of profits from an investment in a domestic or foreign partnership; and
- Dividends received from a domestic corporation in which the taxpayer holds an interest of at least 15% (10% in a case where the E.U. Parent-Subsidiary Directive is applicable) since the beginning of the tax year, provided this corporation (almost exclusively) generates active income. However, the active business requirement is not applicable with respect to companies resident in an E.U. Member State.

EARNINGS STRIPPING RULES

General Concept

Within the 2008 Business Tax Reform Act, earnings stripping rules were introduced to German income tax law to replace the former thin capitalization rules.[8]

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[7] Sec. 3c, para. 1 Income Tax Act ("I.T.A.").

[8] Sec 4h I.T.A., Sec 8a C.I.T.A.

The earnings stripping rules apply, in general, to all types of debt financing for sole entrepreneurships, partnerships, and corporations. The scope of the rules is far broader than the former thin capitalization rules, as any third-party debt financing (whether or not there is back-to-back financing) will be included. Interest expense is completely deductible from the tax base only to the extent that the taxpayer earns positive interest income in the corresponding financial year. Interest expense in excess of interest revenue (the "net interest expense") is deductible only up to 30% of tax E.B.I.T.D.A. (the "interest deduction ceiling").

Tax E.B.I.T.D.A. is defined as taxable profit before application of the interest deduction ceiling, increased by interest expenses and by fiscal depreciation and amortization, and reduced by interest earnings.

For purposes of the earnings stripping rules, the controlling company and the controlled companies of a tax group are treated as a single entity. Thus, the earnings stripping rules are not applicable at the level of the controlled company. The interest expense and interest revenue of the controlled company and the controlling company are aggregated.

Nondeductible interest expenses in a considered period may be carried forward ("interest carryforward"). They increase the interest expenses in the following year, but they are not taken into account to determine the tax E.B.I.T.D.A. On the other hand, any tax E.B.I.T.D.A. amount that is not consumed by interest expenses for the purposes of the earnings stripping rules may also be carried forward ("E.B.I.T.D.A. carryforward"). If the business is closed or transferred to a third party, the interest carryforward and the E.B.I.T.D.A. carryforward are fully lost. If a partner in a business partnership transfers the partnership interest to a third party, the carryforwards are canceled proportionally.[9] Loss carryforwards (see discussion below) are also canceled.

"The earnings stripping rules apply, in general, to all types of debt financing for sole entrepreneurships, partnerships, and corporations."

Exemptions

The earnings stripping rules do not apply provided that interest expense exceeds positive interest income by less than €3 million (the "tax threshold"). Thus, small and medium business enterprises are generally exempt from the scope of the earnings stripping rules.

Furthermore, the earnings stripping rules do not apply to businesses that are not members of a controlled group. A business is regarded as part of a controlled group if it is, or at least may be, included in consolidated financial statements in accordance with I.F.R.S., E.U. G.A.A.P. (*i.e.*, G.A.A.P. of an E.U. Member State), or U.S. G.A.A.P. principles. In principle, consolidated financial statements must be drawn up in accordance with I.F.R.S. Consolidated financial statements in accordance with any E.U. G.A.A.P. can be used if there is no obligation to prepare I.F.R.S. consolidated financial statements and no I.F.R.S. consolidated financial statements have been prepared in the five preceding years. Consolidated financial statements in accordance with U.S. G.A.A.P. can be used if there is neither an obligation to prepare I.F.R.S. consolidated financial statements nor consolidated financial statements according to the G.A.A.P. of any E.U. Member State.

Moreover, there is an escape clause for businesses that are part of a controlled

[9] Sec. 4h para.5 I.T.A

group. Provided that the equity ratio of the entity in question is greater than or equal to the equity ratio of the controlled group, the earnings stripping rules do not apply. There is a 2% safety cushion for the equity ratio of the business in question. As a consequence, the escape clause is still met when the equity ratio of the entity is 48% and the equity ratio of the controlled group is 50%. The calculation of the equity percentage of the business must be based on the values of the assets and liabilities as reflected in the consolidated financial statements.

The exemption for non-controlled corporations and the escape clause apply only if the corporation establishes that remuneration on shareholder debts accounts does not exceed 10% of the net interest expense.[10] Shareholder debt is defined as debt that is granted by a substantial shareholder,[11] by an affiliated person, or by a third party having recourse against a substantial shareholder or affiliated person. Debt financing between companies of the same consolidated group is not adversely affected by these rules. The Federal Supreme Tax Court has raised concerns as to whether in some cases of third party financing these rules violate the constitutional right of equal treatment. A final decision has not yet been reached.

LOSS CARRYFORWARDS

As a general rule, losses may be carried forward to the following fiscal years. The deduction of losses incurred in previous years is only limited by the so-called "minimum-taxation rules."[12] According to these rules, losses may only be deducted from recent profits up to an amount of €1 million. Of the losses in excess of this amount, only 60% may be deducted. The nondeductible 40% of the exceeding amount will again be carried forward.

However, in the event of a transfer of more than 25% of the shares in a company within a five-year period, the portion of the losses representing the transferred shares will be lost. If more than 50% of the shares are transferred within five years, all of the loss carryforward will become nondeductible.[13] This is a critical point when investing in companies because (oftentimes considerable) loss carryforwards cannot be used after the acquisition of the target to compensate for the profits resulting from financial restructuring measures.

C.F.C. TAXATION

German tax law provides specific regulations for a shareholder of a Controlled Foreign Corporation ("C.F.C.") that curtail the perceived abuse of shifting income into low-tax jurisdictions. The C.F.C. rules apply if:

- More than 50% of the share capital or voting rights in the foreign corporation are held by taxpayers who are subject to unlimited tax liability in Germany;
- The foreign corporation generates so-called passive income; and

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[10] Sec. 8a, para. 2 C.I.T.A.

[11] Shareholder of more than 25%.

[12] Sec. 10b I.T.A.

[13] Sec. 8c C.I.T.A.

- The foreign corporation is subject to low taxation (*i.e.*, its effective tax burden, as determined according to German tax principles, is below 25%).

Passive income is defined as income that is not explicitly classified as active under the C.F.C. regulations. Classified active income includes income from manufacturing, trading, the provision of services, and some forms of licensing and renting, with the exception of certain structures designed to reallocate taxable income from Germany to a tax haven. Dividends, constructive dividends, and, in principle, capital gains are active income as well. The classification of capital gains as active income depends on the activity of the sold company.

Special rules apply for companies generating investment type income.[14] Investment type income derived by a C.F.C. can be apportioned to a German shareholder owning, directly or indirectly, at least 1% of the shares of the C.F.C. The C.F.C. rules also apply where the ownership interest is less than 1% if the foreign company derives gross revenue that exclusively or almost exclusively gives rise to investment type income, unless the principal class of the foreign company's stock is actively traded in significant volume on a recognized stock exchange.

If the aforementioned conditions are fulfilled, passive income as determined under German tax legislation is apportioned to all German-resident individual and corporate shareholders. The apportioned income is treated as a profit distribution received in the year following the year in which it is realized by the C.F.C. The German shareholder does not benefit from applicable treaty provisions, and the general dividend exemption does not apply.[15]

"No dividend withholding tax will be levied on dividends paid to a parent company."

Losses of the C.F.C. are not deductible by the German shareholder, but they may be carried forward or backward against profits of the C.F.C. to offset the C.F.C. dividend income of the shareholder.

An exemption from the C.F.C. rules applies for a C.F.C. with a registered office or place of management in a member country of the European Union or European Economic Area, provided that the company carries on "genuine economic activities" in that country.[16] Genuine economic activities require a fully-fledged business with an appropriate office, employees, and technical equipment and are, in general, determined by the criteria established by the European Court of Justice ("E.C.J.") in the *Cadbury Schweppes* decision. Only income that is attributable to the genuine economic activity and is derived by that particular activity (and only insofar as the arm's length principle is observed) is exempt from the C.F.C. rules.

DIVIDEND WITHHOLDING TAX

A nonresident's dividend income is subject to withholding tax collected at the source. The statutory rate of German withholding tax is 25% (plus a solidarity surcharge of 5.5%). Foreign corporations may claim a refund of two-fifths of the withholding tax (resulting in an effective withholding tax rate of 15% plus solidarity surcharge). In many cases, lower rates will be levied by virtue of a double tax treaty. No dividend

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[14] Investment type income is income generated from liquid assets such as cash, securities, and participations.

[15] Sec. 10 para. 2, sent. 3 Foreign Relations Taxation Act ("F.R.T.A.").

[16] Sec. 8 para. 2, F.R.T.A..

withholding tax will be levied on dividends paid to a parent company resident in the E.U., if the parent has been holding a participation of at least 10% in the subsidiary for the last 12 months.[17]

However, Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies and has modified these rules in order to avoid further requests for changes from European Commission.[18] A foreign company is denied a reduced withholding tax rate to the extent it is owned by persons who would not be entitled to a reduced rate if they would have derived the income directly and at least one of the following conditions applies:

- A foreign corporation may not claim to be exempt from the withholding tax on dividends insofar as its shareholders would not be entitled to this benefit, if they receive the dividends directly; and
- The gross-income of the respective company in the respective fiscal year does not come from its own business activities; and
- There are no economic or other substantial reasons for involving that company; or
- The company has no business of its own set up to take part in general business activities.

Nevertheless, the aforementioned anti-treaty-shopping rules may still be considered to be in violation of European law, and the European Commission may request that the Federal Republic of Germany amend these rules. If Germany fails to react to a formal request, the case may go before the E.C.J.

For shareholdings of less than 10%, withholding tax is applicable for both resident and nonresident shareholders. A different holding percentage may be applicable under the various treaties that are in effect.

TRANSFER PRICING

German Administrative Principles

The German tax authorities are empowered to adjust reported income from transactions between related parties that are carried out on a non-arm's length basis, if the transfer price otherwise agreed upon by the parties would lead to lower taxable income in Germany.

The standard transfer pricing methods approved by the legislators are the comparable uncontrolled price method, the resale price method, and the cost-plus-method. In practice, these standard methods may be extended to include other elements, such as global cost allocations. Under certain circumstances, profit-based global methods such as the profit split method and the transactional net margin method are accepted by the German tax authorities. The comparable-profit method is not accepted. A hypothetical arm's length test will be applied if it is not possible to determine arm's length transfer prices on the basis of a recognized transfer pricing methodology.

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[17] Sec. 43b para. 2 I.T.A.

[18] Sec. 50d, para. 3 I.T.A.

It should be noted that, whether or not the requirements of the arm's length principle are met, business expenses in favor of majority shareholders are only tax deductible if the expenditures are made on the basis of clear and unambiguous agreements concluded in advance of the transaction. Charges made to German corporations without a clear and unambiguous advance agreement will be treated as a formal constructive dividend even if the transaction is carried out at arm's length.

From 2013, the arm's length principle is also applicable for any transaction with a permanent establishment.

"As of 2008, provisions on the transfer of functions are included in the German transfer pricing legislation."

Transfer of Functions

As of 2008, provisions on the transfer of functions are included in the German transfer pricing legislation. This this relates to a function that is relocated abroad with the associated opportunities and risks, including the assets and other benefits, also being transferred or otherwise provided. In principle, a payment in consideration of the transfer shall be calculated for the transfer as a whole. The calculation of this payment is to be based on the impact of the function shifted on the profits of the transferring and receiving companies. The administration issued an extensive legal decree ("*Funktionsverlagerungsverordnung*") in July 2008 and administrative guidelines with practical examples in October 2010.

Documentation Requirements

Germany has introduced extensive rules regarding transfer pricing documentation and penalties. According to the rules, a German taxpayer must document the type of cross-border business transaction carried out with a related party or a permanent establishment abroad and the reasons for setting the transfer price. For extraordinary business transactions, documentation must be prepared on a contemporary basis. On the other hand, for ordinary business transactions, documentation must be presented within 60 days (and for extraordinary transactions, within 30 days) of a request during a tax audit. The Federal Ministry of Finance has issued a federal ordinance on transfer pricing documentation obligations, which has been further enhanced by a decree from the German tax authorities.

If a taxpayer fails to comply with the documentation requirements, there is a rebuttable presumption that the income of the German taxpayer is understated. The tax authorities are granted broad discretion to estimate income of the taxpayer from the transaction. In addition, penalties may be due. The penalties range from 5% to 10% of the additional estimated income, with a minimum penalty of €5,000. If documentation is not presented on a timely basis, penalties of €100 may be imposed for each day of the delay, up to €1 million.

B.E.P.S.

The German government is enthusiastic about implementation of the B.E.P.S. Project into German tax law. Nevertheless, no explicit rules have entered into force as of June 9, 2015, although several proposals are under consideration. One such proposal amends the general principles of German income tax law so as to combat hybrid instruments and double non-taxation or "double dip" structures. In broad terms, expenses would not be deductible by the payor if the recipient or its indirect owner does not include the payment in its tax base. Under an accompanying

proposal, expenses would not be deductible in Germany if the same expenses are deductible in another country.

Because of the criticism generated by these proposals, a working group comprised of members of the federal and state tax administrations has been empanelled to develop more acceptable proposals that will be better tailored to combat tax evasion. It is expected that a new legislation will be adopted later this year.

In addition, the government intends to implement amended rules reflecting several of the measures adopted by the O.E.C.D. in the B.E.P.S. Action Plan. These will likely include measures relating to transfer pricing, license income, and the digital economy. The German government intends to act once a final report is issued by the O.E.C.D.

CYPRUS

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GENERAL

Now that the effects of the financial crisis have been addressed, Cyprus remains an active and well-structured international business center catering to the requirements of international businessmen and business entities.

The key factors contributing to the status of Cyprus as an international business base for holding companies remain:

- Its strategic geographic location;
- A favorable tax package with one of the lowest corporate tax rates in Europe;
- A well-developed double tax treaty network;
- A legal system and legislation based on English law; and
- The existence of an efficient, high-level professional services sector.

The Constitution of Cyprus and international treaties ratified by Cyprus safeguard the basic rights of legal entities and individuals.

The main tax provisions relating to Cyprus holding companies have not been revised in recent years. However, tax structures are now carefully scrutinized with regard to the commercial reasoning behind various arrangements.

Cyprus has two revenue raising measures that should be considered when planning to use Cyprus as a base for a holding company. One is the income tax, and the other is the defense levy. Each is discussed in turn.

INCOME TAX

Tax Rate

The flat-rate tax on annual net profit is 12.5%.

Basic Concept

Both Cyprus-resident companies and individuals are taxed on their worldwide income, which includes the following:

- Business income;
- Rental income;
- Dividends, interest, and royalties;
- Goodwill; and
- Employment income, pensions, and director's fees.

For companies not resident in Cyprus, tax is limited to the following categories:

- Profits of a permanent establishment in Cyprus;
- Rental income on immovable property in Cyprus;
- Goodwill for a Cyprus business; and
- Royalties.

For individuals not resident in Cyprus, tax is only levied on the following:

- Employment income for services in Cyprus;
- Pensions received in Cyprus;
- Directors' fees;
- Rental income on immovable property in Cyprus;
- Royalties; and
- Fees paid to professionals.

Residence

The concept of residency status for corporations was adopted in 2003, and tax liability in Cyprus is dependent upon the status of a company as a resident. This is determined by examining the exercise of management and control of the company in Cyprus.

Although "management and control" is not defined in Cypriot tax legislation, it is generally accepted to be in line with international tax principles, namely, that the following conditions should be considered when determining if a company qualifies as a resident of Cyprus for tax purposes:

- All strategic (and preferably also day-to-day) management decisions are made in Cyprus by directors exercising their duties from Cyprus. This is usually achieved by holding meetings of the Board of Directors in Cyprus and signing written resolutions, contracts, agreements, and other relevant company documents relating to the management, control, and administrative functions of the company in Cyprus;
- The majority of the directors of the company are tax resident in Cyprus and exercise their offices from Cyprus;
- A physical (administrative) office is maintained in Cyprus, where actual management and control of the business is exercised;
- Hard copies of commercial documentation (*e.g.*, agreements, invoices, etc.) are stored in the office facilities of the company;
- Accounting records of the company are prepared and kept in Cyprus; and
- Bank accounts of the company are operated from Cyprus, even if the accounts are maintained with banks established outside Cyprus.

"Residence... is determined by examining the exercise of management and control..."

"Although 'management and control' is not defined...it is generally accepted to be in line with international tax principles."

Permanent Establishment

The definition of "Permanent Establishment" in Cypriot income tax law follows the definition found in Article 5 of the O.E.C.D. model convention. As defined, it includes:

- A place of management,
- A branch,
- An office,
- A factory,
- A workshop, and/or
- A building site or construction activities exceeding three months.

Income Subject to Tax

As a general rule, residents of Cyprus are taxed on worldwide income. However, several important exceptions apply to this rule. They may be summarized as follows:

- Profits from the activities of a Permanent Establishment outside of Cyprus are exempt.
- Interest income derived from trading activities is subject to the flat 12.5% tax rate, and this is the only tax payable for interest income from ordinary trading activities. Interest income derived from investments attracts the Special Defense Levy, which is discussed below.
- For corporations, gains from trading in stocks, shares, and securities are generally exempt from income tax. The definition of securities has recently been substantially expanded to grant a broader exemption for Cyprus holding companies that deal in securities. The expanded definition is discussed in in the following section.
- Dividends paid into a Cyprus holding company are exempt from income tax, and no withholding tax is payable when dividends are paid by a Cyprus holding company to its nonresident shareholders. The combination of an exemption for share gains and an absence of tax on dividend income received or paid by a Cyprus holding company likely accounts for the notable increase in the number of nonresident-owned holding companies in Cyprus since its accession to the European Union.
- A unilateral tax credit is allowed in Cyprus for taxes withheld or paid in other countries where there is no bilateral agreement or double tax treaty in force.

New Expanded Definition of Securities

Pursuant to I.T.L. §8(22), the following instruments are considered to be securities for purposes of the exempt capital gains rules in Cyprus:

- Short positions in titles;
- Rights of claim on bonds and debentures;
- Options on titles;

- Founders shares;
- Units in open-end and closed-end collective schemes;
- Index shares or Index bonds;
- Futures/forwards on titles;
- Preference shares;
- Swaps on titles;
- Repurchase agreements or repos on titles;
- Depositary receipts on titles;
- Participations in companies; and
- Shares in L.L.C.'s registered in the U.S.

Tax Losses Group Relief

Tax losses can be offset without restriction against the profits of another company within a group of companies provided the parties are Cyprus-resident companies. In this way, group companies can consolidate results so that the losses of one company can be offset against the profits of another.

Reorganization of Companies

The E.U. directive on mergers, acquisitions, and spin-offs has been implemented in Cyprus. Consequently, mergers, divisions, transfers of assets, and exchanges of shares can be effected without the imposition of income tax. In addition, the losses of the target company may be transferred to the acquiring company provided that both companies are Cyprus tax residents and certain conditions are met.

The scope of the exemption is broad. Gains resulting from the exchange of shares in a merger or reorganization will not be subject to tax. When immovable property is included in the reorganization, capital gains on the transfer will not be subject to Capital Gains Tax. No land transfer fees will be payable on the transfer of immovable property, except if the property is located in Cyprus.

Specific Income Tax Benefits

Certain types of income are subject to favorable tax treatments. These may be summarized as follows:

- Under the reciprocal exemption provisions, in the case of a shipping and aircraft business, profits or benefits arising from the business of operating ships or aircraft are exempt from tax in Cyprus if they are carried on by a person who is not a resident of Cyprus, provided that the Cypriot Minister of Finance is satisfied that there is an equivalent exemption from income tax granted by the country in which such person is resident to persons resident in Cyprus who carry similar business in that other country.
- The income of ship-owning companies is tax-exempt, as well as V.A.T.-exempt.
- Ship management income is subject to tax under the new Tonnage Tax

legislation, which reduces taxation to very low effective rates. However, there are specific conditions to be met for this to be implemented; otherwise, the 12.5% corporate rate applies.

- Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the effective rate of 5% of the amounts paid. A similar rate of tax is imposed on film-rental income derived by a nonresident. However, the E.U. Royalties Directive applies in the case of film rentals.
- Royalties granted for the use of intellectual property rights outside Cyprus are not subject to withholding tax.
- Royalties granted for the use of intellectual property rights outside Cyprus to a Cyprus-resident company are not subject to withholding tax, and corporate income tax is applied only on the profit margin left in the Cypriot company at an effective rate of 2.5% on net income.

"Whenever a loan or other financial instrument is provided to individual shareholders or directors of a company...the recipient is deemed to receive a benefit of 9% per annum."

Specific Allowances and Deductions

Cyprus income tax law now imposes stricter limitations on the ability of a corporation to deduct expenses when calculating net annual taxable income.

Amendments to the Cyprus Income Tax Law

Following recent amendments, the 9% notional interest on loans or other financial facilities has been eliminated, but if Cyprus-resident individuals are the recipients, such loans are considered to be benefits and are taxed as personal income. For corporate shareholders, the arm's length principle will now be applicable, and much lower interest rates are accepted. Regarding back-to-back loans, once more, no notional interest rates will be applied.

Whenever a loan or other financial instrument is provided to individual shareholders or directors of a company (or to their first- or second-degree relatives), the recipient is deemed to receive a benefit of 9% per annum, calculated on the outstanding balance of the loan on a monthly basis. This benefit is assessed in the hands of both resident and nonresident directors and shareholders. In the case of nonresident directors and shareholders, the benefit should be deemed to arise only in relation to the days that they physically spend in Cyprus (on a *pro rata* basis).

Also, no restriction is imposed on interest with respect to the acquisition of shares of a, directly or indirectly, wholly-owned subsidiary company, provided that the subsidiary does not hold assets that are not used in the performance of its business.

Losses may be offset within a group of companies, even if derived in the year in which an entity is incorporated.

In order to encourage investment, factories and machinery acquired during the years 2012, 2013, and 2014 are permitted a 20% depreciation allowance rather than the standard allowance of 10%.

Payroll costs and contributions are not tax deductible if contributions to the Social Insurance Fund, Redundancy Fund, Human Resources Development Fund, Social Cohesion Fund, Pension Fund, and Provident Fund are not paid in the year in which they are due.

According to the I.P. Box regime introduced in 2012, a Cyprus-resident I.P. owner will not be required to pay tax on royalties received from a zero-tax country, and an 80% deduction may be claimed on royalties received prior to taxation in Cyprus.

Penalties

Additional penalties exist for late payment of withholding tax with respect to royalties, film rights, and other Cyprus-sourced income derived by nonresidents. In the case of non-Cyprus residents deriving income from sources within Cyprus (where the income is subject to withholding tax under the provisions of the Cyprus Income Tax Law), the payer is obliged to withhold tax at the source and submit the withholding by the end of the month following that in which payment was made.

If payment is not made by the deadline set by legislation or in a notification by the Commissioner of Income Tax, an additional penalty of 5% will be payable on the amount of tax due.

THE SPECIAL CONTRIBUTION FOR THE DEFENSE OF THE REPUBLIC

The second revenue raising measure in Cyprus is the Special Defense Levy. It is a separate income tax imposed on certain dividends and interest.

- The Special Defense Levy on interest income from investments has now increased from 15% to 30%, but this only applies to residents of Cyprus. Furthermore, interest received in the ordinary course of business is exempt from the Special Defense Levy.
- Nonresident shareholders of Cyprus-resident companies are not subject to the Special Defense Levy.
- Dividends paid from one Cyprus-resident company to another are exempt. Dividends received by a resident company from a nonresident are also exempt if (i) the investment income of the nonresident company is less than 50% of its total income or (ii) the foreign tax burden is not substantially lower than the tax burden in Cyprus. This condition is met if either alternative is met. The term “substantially lower” is not defined within Cypriot law and is, therefore, left to the discretion of the tax authorities.

Penalties

New amendments impose much higher and stricter penalties for noncompliance with the provisions of Special Contribution for the Defense of the Republic.

OTHER TAXES

Capital Gains Tax

Capital Gains Tax is not applicable to profits earned from the sale of securities, as seen above, but it is applicable to real estate sales within Cyprus.

Inheritance and Estate Taxes

There are no such taxes on shares held in a Cyprus company.

Thin Capitalization Rules

Cyprus tax law does not contain specific thin capitalization or transfer pricing rules. Nonetheless, transaction values in related party transactions should be based on the "arm's length principle."

ARM'S LENGTH TRANSFER PRICING

Section 33 of the tax law provides that where:

i. A Cyprus business participates directly or indirectly in the management, control, or capital of a business of another person, or the same persons participate directly or indirectly in the management, control, or capital of two or more businesses; and

ii. Commercial or financial relations between said businesses differ substantially from those that would exist between independent businesses;

Any profits that would have accrued to one of the businesses in absence of these special conditions may be included in the profits of that business and be taxed accordingly.

This provision allows the Inland Revenue Department to adjust the profits of a resident company or other person for income tax purposes where it is of the opinion that, because of the special relationship between the Cyprus-resident person and the other party to a transaction, the Cyprus profits have been understated.

CHANGES IN TAX REGISTRATION PROVISIONS

Regarding the obligation to register for a Tax Identification Code ("T.I.C.") in Cyprus, although a company should register itself with the Cyprus Tax Authorities, a legal framework did not previously exist for such registration or for non-compliance penalties.

Now, a company is obliged to submit the relevant return and obtain a T.I.C. within 60 days of the date of its incorporation. Failure to comply will now result in heavy fines.

EXCHANGE OF INFORMATION AND BANK CONFIDENTIALITY RULES

Cyprus is a signatory of the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This is a multilateral agreement to exchange information and provide assistance on the basis of inquiries from one signatory state to another.

Consequently, if and when the Cyprus Tax Authorities receive an inquiry from the tax authority of another signatory state, Cyprus is obliged in practice to provide such information, so long as certain conditions of the local legislation are satisfied. Fishing expeditions will not be permitted.

Information Requests

Following recent amendments, the Director of Inland Revenue (the "Director"), after obtaining written consent from the Attorney General ("A.G.") and furnishing the person under investigation with a relevant written notice, retains the right to request any bank to provide any information it possesses in relation to any existing or closed bank account of a person under investigation by the tax authorities, relating to the period of up to seven years preceding the date of the request.

"Various E.U. Member States and other jurisdictions now require more detailed explanations from clients using Cypriot private companies within their structures."

In order for the consent of the A.G. to be granted, the Director should apply to the A.G. and furnish both the A.G. and the bank with:

- The identity of the person under examination;
- A description of the information requested, including the nature and manner in which the Director wishes to receive the information from the bank;
- The reasons which lead to the belief that the requested information is in the custody of the bank;
- The period of time for which the information is requested (the time period should be both specific and reasoned); and
- A declaration that the Director has exhausted all means at his/her disposal to obtain the requested information, except where resorting to such means would have imposed an undue burden.

The Director must inform the A.G. of the tax purpose and the reasons for which the information is requested.

Furthermore, the Director must inform the person under investigation of the written consent or of the refusal of such consent by the A.G. as soon as this information is made available.

Provision of Information by Civil Servants

The confidentiality bar on civil servants is now removed, and civil servants are now under the obligation to reveal to the tax authorities, upon request, any information they may have on taxpayers.

Bookkeeping and Field Audits

Following the provision of a reasonable notice to the interested party during a field audit, the Director is entitled to enter and inspect any business premises, building premises, or rooms (during business hours), except residential dwellings, including any goods and documents found in them.

MORE STRINGENT REQUIREMENTS FROM THE E.U. AND OTHER JURISDICTIONS

Various E.U. Member States and other jurisdictions now require more detailed explanations from clients using Cypriot private companies within their structures. Such disclosures include the length of time shares are held, copies of the transaction

documents, confirmations from the Board of Directors that the Cypriot company is managed and controlled in Cyprus, as well as the extent of an actual physical presence in Cyprus.

With planning, proper record keeping, and adoption of rules regarding economic substance, corporate residents of Cyprus have successfully claimed treaty benefits from foreign tax authorities.

DOUBLE TAX TREATIES

Cyprus has developed an extensive network of double tax treaties that offer excellent opportunities for international tax planning for a wide range of businesses.

Double tax treaties are in effect with the following countries:		
Armenia	Hungary	Romania
Austria	Iceland	Russia
Belarus	India	San Marino
Belgium	Ireland	Serbia
Bulgaria	Italy	Singapore
Canada	Kuwait	Slovakia
China	Kyrgyzstan	Slovenia
C.I.S. States*	Lebanon	South Africa
Czech Republic	Lithuania	Spain
Denmark	Mauritius	Sweden
Egypt	Montenegro	Syria
Estonia	Moldova	Tajikistan
Finland	Norway	Thailand
France	Poland	Ukraine
Germany	Portugal	United Arab Emirates
Greece	Qatar	United Kingdom
* The treaty concluded between Cyprus and the former U.S.S.R. is applicable to Azerbaijan and Uzbekistan, Republics of the Commonwealth of Independent States ("C.I.S."), until such time they wish to abrogate the treaty.		

In addition, Cyprus concluded new treaties with Switzerland and Guernsey in 2014. The new treaties will enter into force once both countries conclude their ratification procedures.

THE B.E.P.S. ACTION PLAN - HOW CYPRUS WILL BE AFFECTED

Action 10

Cypriot companies are often used to provide administrative services to intra-group companies. Following the implementation of Action 10, it is necessary for the Cypriot company to maintain the necessary infrastructure and substance to provide these services from a base in Cyprus. In particular, the Cypriot entity must demonstrate that it has incurred sufficient costs to justify a "Cost Plus" transfer price for services to intra-group companies. If real costs are not incurred, the fee will be reduced in the course of a tax examination in the jurisdiction of residence for the related party.

Action 6

A Limitation of Benefits ("L.O.B.") provision is expected to be included in new treaties concluded by Cyprus. The provision will deny treaty benefits to structures in which the Cypriot company does not maintain sufficient contact with Cyprus.

It is expected that pressure will be placed on Cyprus to amend existing double taxation treaties to include an L.O.B. provision.

Action 8

Since 2012, a special tax regime known as the "I.P. Box" has allowed the owner of an intangible asset to receive a significant deemed deduction on I.P. revenue. Subsequent to implementation of Action 8, it will become a prerequisite that intangible assets are developed in Cyprus in order to claim any tax benefits. With the introduction of this "nexus approach," it will be difficult for many international businesses to continue to take advantage of the Cypriot I.P. Box regime beyond the expiration of the grandfather period that runs through the end of the year 2021. For the benefit to extend further, the Cypriot government must develop a program outside the bounds of low tax for I.P. Box companies that provide incentives, making Cyprus an ideal location for the internal development of intangibles.

MALTA

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GENERAL OVERVIEW OF BUSINESS FORMS AND RESPONSIBILITIES

Forms of Business

Malta is distinctive for its hybrid body of law, which blends traditional civil law and U.K. common law principles and has been further refined by E.U. regulations and directives. The result is a unique body of pragmatic law with international application.

The Companies Act traditionally envisages three forms of commercial arrangements as vehicles for conducting business: the partnership *en nom collectif*, the partnership *en commandite*, and the limited liability company. Each has its particular features and advantages. The initial two arrangements have decreased in popularity and have significantly been replaced by the limited liability company, which provides limited liability and separate juridical personality.

Generally, the limited liability company – whether exempt or non-exempt private, single-member, financial holding,[1] or public – is universally used as the vehicle for conducting any kind of business activity without territorial limitation.

In addition, new laws allow for the increased use of the S.I.C.A.V. and the I.N.V.C.O. for companies undertaking the provision of investment services.

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[1] In terms of Article 172 of the Companies Act, an L.L.C. is deemed to be a financial holding company under the following conditions:

(a) It has not intervened, directly or indirectly, in the management of a subsidiary during the relevant accounting period;

(b) It has not exercised the voting rights attached to a participating interest with respect to the appointment of a member of the board of directors of a subsidiary during the accounting period in question and the five preceding accounting periods; or, where the exercise of voting rights was necessary for the operation of the board of directors of the subsidiary, such voting rights were exercised without any interference or influence on the part of the L.L.C. or of any other subsidiary, and no member of the board of directors of the subsidiary undertaking:

(i) Has majority voting rights in that L.L.C.;

(ii) Is a member of the board of directors of that L.L.C; or

(iii) Is a member of the board of directors of a member with majority voting rights in that L.L.C.; and

(c) The L.L.C. has only made loans to undertakings in which it holds participating interests or, where such loans have been made to other parties, they have been repaid by the end of the previous accounting period.

S.I.C.A.V. incorporated cell companies and recognized incorporated cell companies have been used in connection with structuring multi-class or multi-fund professional investment funds.

The insurance sector regularly uses the protected cell company and the incorporated cell company as vehicles to conduct insurance business.

Securitization cell companies have become increasingly common. They may establish an infinite number of segregated cells in the performance of securitization transactions, and the assets and liabilities contained within one cell are independent of the assets and liabilities in all other cells.

Governance and Responsibilities

The management of a Maltese company rests with its board of directors. Members of the board may be individuals or corporate entities. Directors are not required to be resident in Malta, although the appointment of Maltese residents may be advisable as a symbol of substance in Malta. In certain licensable activities – primarily investment services – the appointment of Maltese-resident directors may be imposed as a licensing condition by the Malta Financial Services Authority ("M.F.S.A.").

The M.F.S.A. has issued corporate governance guidelines with respect to the management of public companies. The guidelines are intended to promote a desired standard for members of the board of directors. Although not obligatory, the guidelines represent best practice and are recommended in connection with the management and administration of larger private companies.

The directors of a Maltese company are personally responsible for the company's compliance with fiscal legislation and are consequently liable for the tax due by the company. Responsibility for obligations imposed by the Value Added Tax Act ("V.A.T.") extends to all directors and officers of a company, including the company secretary and persons occupying managerial positions. Comparable liability is imposed on a liquidator of a company in the process of liquidation. Although court decisions vary, the prevalent view is that all officers are under an obligation to ensure that the company is compliant with its fiscal obligations under the Value Added Tax Act.

Identical obligations are imposed upon the directors with regard to the registration of employment contracts and the fulfillment of monthly and annual compliance with social security obligations.

Audit Requirements

In Malta, the preparation of audited financial statements is regulated by the Companies Act, the Maltese Income Tax Acts, and the Accountancy Profession Act. Financial statements are prepared in accordance with the International Financial Reporting Standards ("I.F.R.S.") or under Maltese Generally Accepted Accounting Principles, as permitted by the Accountancy Profession Act.

As a general rule, all companies are subject to a mandatory audit of their annual reports and financial statements. However, stand-alone "small companies"[2] and

[2] Pursuant to Article 185(1) of the Companies Act, small companies do not exceed two of the following thresholds, as reported on their balance sheets: (a)

"small groups"[3] of companies are not required to have their financial statements audited. Nonetheless, audited financial statements may be required under the Income Tax Acts in specific circumstances.

As a general rule, the Companies Act requires the preparation of consolidated accounts whenever a Maltese company is the parent of a subsidiary, regardless of where the registered offices or principal offices of the subsidiaries are located. Certain exemptions apply to (i) private exempt companies, (ii) single-member companies, and (iii) financial holding companies.[4]

Specific Industry Incentives

The Maltese Aircraft Registry was launched in 2010, building on the success of the Maltese Shipping Registry, which is the E.U.'s largest registry. Favorable rules exist with regard to income tax, tonnage tax, and V.A.T. for yacht-leasing operations, short-term yacht chartering, and aircraft-leasing arrangements.

Specific fiscal incentives launched by the Maltese government in various business sectors include exemptions for royalty income derived from the exploitation of patents, copyrights, and trademarks intended to transform Malta into an intellectual property ("I.P.") hub and tax incentives for lotteries and gaming.

Malta provides a low tax rate (15%) on a portion of income of individuals employed under a qualifying contract in eligible offices.[5]

Balance Sheet Total of €2,562,310.74; (b) Turnover of €5,124,621.48; and (c) Average Number of Employees during the Accounting Period of 50; and small private companies do not exceed two of the following thresholds: (a) Balance Sheet Total of €46,587.47; (b) Turnover of €93,174.94; and (c) Average Number of Employees during the Accounting Period of 2.

3 Pursuant to Article 185(1) of the Companies Act, small groups of companies do not exceed any of the following thresholds: (a) Aggregate Balance Sheet Total of €2,562,310.74 net or €3,074,772.89 gross; (b) Aggregate Turnover of €5,124,621.48 net or €6,149,545.77 gross; and (c) Aggregate Number of Employees of 50.

4 Prior to receiving the relevant exemption, the Registrar of Companies must verify that such entity qualifies as a financial holding company, subject to the conditions set out in Article 172 of the Companies Act.

5 Pursuant to the Highly Qualified Persons Rules of Subsidiary Legislation 123.126, qualifying employment includes employment with companies licensed and/or recognized by the competent authority or with undertakings holding an air operators' certificate issued by the competent authority such as Chief Executive Officer, Chief Risk Officer (including Fraud and Investigations Officer), Chief Financial Officer, Chief Operations Officer (including Aviation Accountable Manager), Chief Technology Officer, Chief Commercial Officer, Portfolio Manager, Chief Investment Officer, Senior Trader/Trader, Senior Analyst (including Structuring Professional), Actuarial Professional, Chief Underwriting Officer, Chief Insurance Technical Officer, Odds Compiler Specialist, Head of Research and Development (including Search Engine Optimization and Systems Architecture), Aviation Continuing Airworthiness Manager, Aviation Flight Operations.

Manager, Aviation Training Manager, and Aviation Ground Operations Manager, Head of Marketing (including Head of Distribution Channels), or Head of Investor Relations; and employment with undertakings holding an aerodrome license issued by the competent authority, consisting of employment as Chief Executive Officer. Pursuant to the Qualifying Employment in Innovation and Creativity (Personal Tax) Rules of Subsidiary Legislation 123.141, which shall remain in force until December 31, 2014 (unless further extended), includes roles directly engaged in industrial research, experimental development, product development, product design, product or process innovation, or senior management.

Malta provides tax incentives and makes Malta Enterprise assistance to businesses that establish factories on Maltese territory for production activities in sector-specific industries.

Malta is a center for international credit institutions that operate as limited liability companies registered under the provisions of the Companies Act and licensed under the Maltese Banking Act by the M.F.S.A. These entities conduct business across the E.U. and the local legislation is compliant with E.U. Directives, such as MiFID, A.I.F.M.D. and E.M.I.R, have entered into force.

TAXATION OF COMPANY PROFITS

Unless an exemption from tax or a special fiscal regime applies to a company as a result of industry-specific or license-specific tax incentives under Maltese law, Maltese companies are generally taxed at the flat rate of 35%. However, the Income Tax Acts allow for certain types of income to be taxed separately at the source, such as:

- Bank interest, which may be taxed at the source at the rate of 15% upon an election by the taxpayer; and
- Immovable property transfers (when performed as a one-off transaction, as opposed to transactions by a company whose trade is immovable property speculation), which, as of January 1, 2015, are by default subject to the Final Withholding Tax of 8%, calculated on the value of the property transferred. A few exceptions may also result in different tax rates, ranging between 2% and 10%.[6]

The tax on trading income is levied on the taxable income earned in the fiscal year being assessed, after accounting for deductible expenses wholly and exclusively incurred in the production of the income. Malta applies the full imputation system of taxation, as a result of which the tax paid by the company is allowed as a credit when dividends are received by the shareholders.

Upon written request, companies that are in compliance with their taxing obligations may be furnished with a Fiscal Residence Certificate issued by the Commissioner for Revenue, proving their fiscal good standing in accordance with Maltese law.

TAX ACCOUNTING

Profits generated by a company are allocated to the final taxed account, foreign income account, immovable property account, the Maltese taxed account, or the untaxed account, depending on the revenue streams flowing into the company. The allocation of profits to these accounts is relevant when considering the distributions made by the company and, in particular, when a shareholder who has received a dividend files an application for a tax refund. Distributions are to be made in the

[6] The 12% tax on property transfers will continue to be applicable with respect to promise of sale agreements registered with the Commissioner for Revenue prior to the November 17, 2014. Transfers of inherited immovable property will remain subject to a 12% final tax on the difference between the transfer value and the cost of acquisition, and to a 7% final tax on the consideration, if inherited before November 25, 1992.

following order of priority: (i) profits allocated to the final tax account, (ii) profits allocated to the immovable property account, (iii) distributions from the foreign income account, and (iv) profits allocated to the Maltese taxed account.

The allocation of profits is classified as follows:

- Final Taxed Account. The profits allocated to this account consist of income that, in accordance with the provisions of the Income Tax Act, is subject to a final withholding tax or upon which no further tax is payable. The full imputation system does not apply to the final taxed account. Distributions from the final taxed account are not subject to further tax.

- Immovable Property Account. The profits allocated to the immovable property account consist of income that is derived from immovable property situated in Malta. Such profits include, *inter alia*, gains on the sale of property, rents, interest on loans to finance the acquisition of property situated in Malta, income from hotel accommodations, insurance premiums related to property situated in Malta, and any other income which is connected with Maltese immovable property. It also includes a notional allocation in those instances where the property is owned by a company and is used for the purpose of its business activities (notional rent).

- Foreign Income Account. The profits allocated to this account consist of income from sources outside Malta and include, *inter alia*, royalties, dividends, capital gains, interest, rents, income derived from participating holdings, and profits attributable to a permanent establishment outside of Malta.

- Maltese Taxed Account. The profits allocated to the Maltese taxed account have been subject to tax generally at the rate of 35%. It also includes profits on which a lower rate of tax has been applied.

- Untaxed Account. The allocation to this account represents the arithmetical difference between the total profits earned by the company and those that are allocated to the various other tax accounts. Distributions out of the untaxed account are subject to a 15% withholding tax if the recipient is a Maltese-resident individual. On the other hand, nonresident individuals and Maltese-resident companies fall outside the definition of "recipient" and, in the case of such distributions, withholding tax is not applicable.

"When a company distributes its profits, the shareholders receiving the dividend are entitled to a refund of the tax paid by the company."

MALTESE REFUNDABLE TAX SYSTEM

The Maltese refundable tax system, as approved by the E.U., offers a significant advantage because when a company distributes its profits, the shareholders receiving the dividend are entitled to a refund of the tax paid by the company. The amount of the refund depends on the nature of the income and the manner in which the income has been allocated to the different tax accounts. The various types of refunds and the circumstances under which they apply are illustrated hereunder:

- Six-Sevenths Refund. The six-sevenths refund is applicable to distributions made from profits allocated to the Maltese taxed account or to the foreign income account where such income does not consist of passive income or royalties.

- Five-Sevenths Refund. The five-sevenths refund applies to distributions of profits derived from passive interest, royalties, and dividends received from participating holdings that do not meet the anti-abuse provisions.

- Full Refund. Shareholders may apply for a full refund of the Maltese tax paid by the company in those instances where a dividend has been paid from profits derived from income received in connection with a participating holding. When such income qualifies for the participation exemption, the company receiving the income may exclude it from the income tax computation. In this instance, such income will be allocated to the final tax account, and no further tax will arise on the distribution of income allocated to this account when paid to non-residents of Malta.

"Any income or gains derived by a Maltese-registered company from a participation in a company or from the transfer of a company qualifying as a participation is exempt from tax."

PARTICIPATION EXEMPTION

Any income or gains derived by a Maltese-registered company from a participation in a company or from the transfer of a company qualifying as a participation is exempt from tax.

With respect to a dividend derived from a participating holding, this exemption applies only when either of the following conditions are satisfied:

- The body of persons in which the participating holding is held satisfies any one of the following conditions: (i) it is a resident of or incorporated in an E.U. Member State, (ii) it is subject to foreign tax at a rate of at least 15%, or (iii) it does not derive more than 50% of its income from passive interest or royalties.

- If none of the above conditions are satisfied, then both of the following conditions must be met in order to qualify for the exemption. First, the equity holding is not a portfolio investment.[7] Second, the passive interest, or its royalties have been subject to foreign tax at a rate which is not less than 5%.

An investment qualifies as a participation where any of the following conditions is met:

- A company holds directly 10% or more of the equity of a company whose capital is wholly or partly divided into shares, and the shareholding confers an entitlement to at least 10% of any two of the following:
  - Voting rights;
  - Profits available for distribution; and
  - Assets available to shareholders upon liquidation.

- A company is a shareholder in another company (the "target company") and is entitled, at its option, to acquire the entire balance of the issued and outstanding shares in the target company held by others;

[7] For this purpose, the holding of shares by a Maltese-registered company in a body of persons not resident in Malta which derives more than 50% of its income from portfolio investments is deemed to be a portfolio investment.

- A company is a shareholder in the target company and holds a right of first refusal over all shares in the target company that are owned by others in the event of a proposed disposal, redemption, or cancellation;
- A company is a shareholder in the target company and is entitled to board participation;
- A company is a shareholder in the target company and the value of its investment was at €1,164,000 at purchase and the investment must be held for at least 183 consecutive days; or
- A company is a shareholder in the target company where the investment was made for the furtherance of its own business and the holding is not maintained for the purpose of a trade.

OTHER EXEMPTIONS

Other exemptions apply, of which the most important include the following:

- Permanent Establishment. Income or gains derived by a company registered in Malta ("the particular company") are exempt from Maltese taxation if they are attributable to a permanent establishment (including a branch) situated outside of Malta, including a sale of the assets of the permanent establishment. For purposes of the exemption, "profits or gains" shall be calculated as if the permanent establishment is an independent enterprise operating in similar conditions and at arm's length.[8]
- Intellectual Property. Royalties, advances, and similar income derived from (i) patents, (ii) copyrights, or (iii) trademarks are exempt from tax in Malta. Profits from exempt income remain exempt at the level of shareholders when distributed by way of a dividend. The exemption continues as dividends are distributed through a chain of shareholders.

TRANSFERS OF SHARES IN A MALTESE COMPANY

Malta imposes a stamp duty on transfers of shares in a Maltese company.

However, an exemption applies to transfers of shares in a Maltese company in which (i) more than 50% of the ordinary share capital, voting rights, and rights to profits are held by persons not resident in Malta (or by the trustee of a trust in which all beneficiaries are not resident in Malta) and (ii) ownership or control is not held, directly or indirectly, by persons resident in Malta. No capital gains tax is due on a transfer by nonresidents. The exemptions do not apply where the company is a company that owns immovable property in Malta.

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[8] If, in the opinion of the Commissioner, a series of transactions is effected with the main purpose of reducing the income tax liability of any person through the operation of the permanent establishment exemption, that a person is assessable as if the exemption did not apply. A series of transactions means two or more corresponding or circular transactions carried out by the same person, either directly or indirectly, as the case may be.

Similar exemptions from stamp duty and income tax liability apply when the value of the ownership (represented by the percentage share capital held or the voting rights held in the company) is shifted from one shareholder to another shareholder by way of the issuance of issue of shares by the company.

DOUBLE TAXATION RELIEF

With respect to the Income Tax Acts, relief from double taxation may take one of three forms: (i) treaty relief, (ii) unilateral relief, or (iii) flat rate foreign tax credit.

Treaty Relief

Treaty Relief is available if all the following criteria are satisfied:

- Under the relevant double tax treaty, the foreign tax paid in the other state is allowed as a credit against tax payable in Malta;
- The foreign tax is of a similar character to the tax imposed in Malta; and
- The person making the claim is a resident of Malta during the year immediately preceding the year of assessment, and tax is payable on such income.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Malta's Double Taxation Treaty network is made up of treaties in force with 68 states:		
Albania	India	Poland
Australia	Ireland	Portugal
Austria	Isle of Man	Qatar
Bahrain	Israel	Romania
Barbados	Italy	Russia
Belgium	Jersey	San Marino
Bulgaria	Jordan	Saudi Arabia
Canada	Kuwait	Serbia
China	Latvia	Singapore
Coatia	Lebanon	Slovakia
Cyprus	Libya	Slovenia
Czech Republic	Liechtenstein	South Africa
Denmark	Lithuania	South Korea
Egypt	Luxembourg	Spain

Estonia	Malaysia	Sweden
Finland	Malta	Switzerland
France	Mauritius	Syria
Germany	Mexico	Tunisia
Georgia	Montenegro	Turkey
Greece	Morocco	United Arab Emirates
Guernsey	Netherlands	United Kingdom
Hong Kong	Norway	United States
Hungary	Pakistan	Uruguay
Iceland		

Double Taxation Treaties have also been signed with Mauritius (October 15, 2014), Moldova (April 10, 2014), and the Ukraine (September 4, 2013), but these have not entered into force yet. Three treaties are currently in various stages of negotiation, *i.e.*, those with Bosnia and Herzegovina, Oman, and Thailand. A protocol on the exchange of information with regard to the treaty in force between Malta and Belgium was signed on January 19, 2010, but as of this publication it is still pending ratification and entry into force.

The double taxation agreement between the U.S. and Malta was signed on November 2, 2010, and entered into force as of January 1, 2011. An earlier agreement that focused only on income from ships and aircraft was terminated in 1997.

Unilateral Relief

In order to claim unilateral relief, the following conditions must be met:

- Treaty relief is not available to the person making the claim;
- The income in question arises outside of Malta and is subject to tax in the state of source;
- The foreign tax is of a similar character to the tax imposed in Malta;
- The person entitled to the income is resident in Malta, or is a company registered in Malta for the year immediately preceding the year of assessment, and tax is payable on such income; and
- The person making the claim proves to the satisfaction of the Commissioner of Inland Revenue that the foreign income has borne foreign tax and proves the amount of the tax.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Flat Rate Foreign Tax Credit

The Flat Rate Foreign Tax Credit is available if the following conditions are met:

- Treaty relief and unilateral relief are not available to the person making the claim;
- Income or gains are received by a company registered in Malta, which includes a Maltese branch of a nonresident company;
- The Company is empowered to receive such income or gains;
- The income or gains are allocated to the foreign income account; and
- Documentary evidence must be available indicating to the Commissioner for Revenue's satisfaction that the income or gains are to be allocated to the foreign income account.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

B.E.P.S. AND OTHER INITIATIVES

"Malta actively participates in initiatives against harmful tax competition."

"It is also an active participant in O.E.C.D. initiatives."

Malta actively participates in initiatives against harmful tax competition, which includes cooperation in foreign tax-related matters. It was one of the first states to enter into an Inter-Governmental Agreement ("I.G.A.") with the United States to allow for the implementation of the Foreign Account Tax Compliance Act ("F.A.T.C.A.").[9] Maltese implementation of the F.A.T.C.A. provisions was published on March 7, 2014.[10] This legislation constitutes a new regime regulating reciprocal exchange of information between Malta and the U.S. The first exchanges between the two states under the I.G.A. are expected to take place by the third quarter of 2015.

Malta is also an active participant in O.E.C.D. initiatives. It forms part of the *ad hoc* group of 83 participating countries[11] mandated by the O.E.C.D. and the G-20 last February to complete work under Action 15, which addresses the development of a multilateral instrument to implement the Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan. Progress toward this deliverable began on May 27, 2015, in Paris, and substantive work is scheduled to commence at meeting in November 2015.

Following the implementation of a 2010 protocol amending the Joint Council of Europe/O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters, Malta ratified the amended convention on May 23, 2013. The Amended Convention was adopted into Maltese law and became effective on September 1, 2013.

The E.U. Administrative Cooperation Directive (Council Directive 2011/16/EU of February 15, 2011 on administrative cooperation in the field of taxation) was adopted into Maltese law effective July 22, 2011.

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[9] Malta and the U.S. signed a Model 1 I.G.A. on December 16, 2013.

[10] See Exchange of Information (United States of America) (F.A.T.C.A.) Order, Legal Notice 78 of 2014.

[11] As of May 28, 2015.

Malta signed an Exchange of Information Agreement with Macau (signed on May 30, 2013, but not yet in force). Other agreements already in force include the Bahamas (January 15, 2013), Bermuda (November 5, 2012), the Cayman Islands (April 1, 2014), and Gibraltar (June 12, 2012).

CONCLUSIONS APPLICABLE TO MALTA

The legal framework in Malta offers a number of key advantages for those seeking to conduct international business in a sound and reputable jurisdiction. The taxation system in Malta contains no thin capitalization rules. Transfer pricing rules are relatively flexible, and there are no withholding taxes on remittances to non-residents with respect to dividends, interest, and royalties. The legislation in Malta permits companies to migrate to and from Malta. Branches of overseas companies enjoy the same tax treatment applicable to companies incorporated in Malta. Incorporation and winding up procedures are relatively easy.

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

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