



# INSIGHTS

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## OUTBOUND ACQUISITIONS: TAX PLANNING FOR EUROPEAN EXPANSION IN A CHANGING LANDSCAPE (2024)

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### About Us

## EDITORS' NOTE

The summer edition of *Insights* is devoted to a holistic examination of cross border tax planning for U.S. companies expanding into Europe. Historically, these plans followed a road map designed to deconstruct business operations, placing production, financing, and I.P. functions in separate group companies based in different countries. If the road map were carefully followed, European taxes on operations could be driven down in ways that did not result in immediate U.S. taxation under Subpart F. Large U.S. based multinationals became expert in navigating the road map. Events beginning in 2015, picking up speed in 2017, and carrying through to 2024 make it unrealistic to believe that old planning strategies still yield benefits. Too many barriers now exist and more will come online annually.

- The first barrier consists of the actions taken by the O.E.C.D. to curtail base erosion and profit shifting through the B.E.P.S. Project.
- The second barrier is a never-ending stream of directives issued by the European Commission and proposals by the European Parliament attacking various tax plans involving affiliated companies and their beneficial owners, with the intent of exposing tax plans to name-and-shame attacks by stakeholders such as nongovernmental organizations and crusading journalists. The latest iteration in the attack on “sharp” planning is A.T.A.D. 3, the “unshell directive,” which has been on hold for several years. Perhaps it will be adopted this year.
- The third barrier consists of several decisions of the European Court of Justice, known as the “Danish Cases,” judicially mandating that all plans must reflect economic substance and business purpose in order to be effective. The target consisted of shell entities having as their only function the receipt of dividends and interest from subsidiaries based in Member States of the E.U. and the payment of dividends and interest equivalents to related parties outside the E.U. The holding effectively adopts the decision in an old U.S. Tax Court case, *Aiken Industries, Inc. v. Commr.*
- The fourth barrier is D.A.C.6, a European Council Directive on Administrative Cooperation, imposing reporting obligations on intermediaries who advise clients or provide services in support of cross-border tax arrangements containing certain hallmarks of abusive tax planning.
- The fifth barrier consists of Pillar One and Pillar Two proposed by the O.E.C.D. in support of the B.E.P.S. project, which proposes to adjust taxing rights of countries touched by large digital businesses and to impose a global minimum tax. At the present time, there is much “jaw boning” about the Pillars, but the degree of traction remains an open question as the U.S. has remained opposed to Pillar One and it is not clear that either Pillar be accepted by the U.S. House of Representatives. Nonetheless, the O.E.C.D. keeps issuing positive press releases that universal adoption of the Pillars will occur in the near future.

In the U.S., the Tax Cuts & Jobs Act (“T.C.J.A.”) turned cross-border tax planning on its head. The T.C.J.A. included many changes to U.S. international tax law. Among its international provisions are:

- The adoption of a dividends-received deduction for intercompany dividends

received from a foreign subsidiary meeting a  $\geq 10\%$  ownership threshold. The deduction replaces the indirect foreign tax credit available to corporations receiving dividends from  $\geq 10\%$  subsidiaries. The move to a “D.R.D.” was accompanied by a transition tax intended to wipe out accumulated post-1986 earnings as of the last day of the taxable year beginning prior to January 1, 2018. The tax affected any U.S. corporation or U.S. citizen or resident individual having a  $\geq 10\%$  interest in the foreign corporation as of De. The validity of the tax was recently affirmed by the U.S. Supreme Court in *Moore v. U.S.*

- The imposition of mandatory gain recognition for outbound transfers of property that will be used in an active trade or business conducted outside the U.S. by a foreign subsidiary.
- The adoption of G.I.L.T.I. provisions on income of controlled foreign corporations. Under prior law, income not taxed immediately under Subpart F benefited from indefinite deferral of tax in the U.S. With limited exception, indefinite deferral has been eliminated for  $\geq 10\%$  U.S. shareholders of C.F.C.’s.
- Attacks on cross-border hybrid transaction among related C.F.C.’s and domestic entities considered to be reverse hybrids in the U.S.

The 2024 summer edition of *Insights* addresses the broad range of impediments that must be overcome in planning cross-border operations. It begins with a detailed overview of post-T.C.J.A. U.S. tax law, comparing old rules with new realities, and a general review of revisions proposed by the current Administration in the U.S. From there, B.E.P.S. provisions applicable on a global basis are addressed, as are Pillar One and Pillar Two. It is followed by a discussion of European attacks on illegal State Aid and abusive tax planning. Several embarrassing losses for the European Commission are discussed, as is an important win for the Danish tax administration and a proposed amendment to A.T.A.D. that attacks shell companies. It concludes with detailed explanations of corporate tax rules in 17 European jurisdictions by recognized experts in the respective countries.

In sum, the 2024 summer edition of *Insights* reflects the current state of acceptable corporate tax planning for European expansion as of its publication date.

We hope you enjoy this issue.

- The Editors



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## AUTHOR CONTACTS

### **JOÃO LUÍS ARAÚJO**

TELLES  
*Porto, Portugal*  
[j.luisaraujo@telles.pt](mailto:j.luisaraujo@telles.pt)

### **NAIRY DER ARAKELIAN-MERHEJE**

Der Arakelian-Merheje LLC  
*Nicosia, Cyprus*  
[enlaw1@cytanet.com.cy](mailto:enlaw1@cytanet.com.cy)

### **GUILLERMO CANALEJO LASARTE**

Uría Menéndez  
*Madrid, Spain*  
[guillermo.canalejo@uria.com](mailto:guillermo.canalejo@uria.com)

### **MICHEL COLLET**

CMS-Francis Lefebvre  
*Neuilly-sur-Seine, France*  
[michel.collet@cms-bfl.com](mailto:michel.collet@cms-bfl.com)

### **DR. STEFAN P. GAUCI**

Attorney-at-Law  
*Malta*  
[spgauci.legal@gmail.com](mailto:spgauci.legal@gmail.com)

### **WERNER HEYVAERT**

AKD Benelux Lawyers  
*Brussels, Belgium*  
[wheyvaert@akd.eu](mailto:wheyvaert@akd.eu)

### **ANDREA HØJGAARD JØRGENSEN**

CORIT Advisory  
*Lyngby, Denmark*  
[ahj@corit.dk](mailto:ahj@corit.dk)

### **PAUL KRAAN**

Van Campen Liem  
*Amsterdam, Netherlands*  
[paul.kraan@vancampenliem.com](mailto:paul.kraan@vancampenliem.com)

### **FABIENNE LIMACHER**

Walder Wyss  
*Zürich, Switzerland*  
[fabienne.limacher@walderwyss.com](mailto:fabienne.limacher@walderwyss.com)

### **ERIK NILSSON**

Svalner Skatt&Transaktion  
*Stockholm, Sweden*  
[erik.nilsson@svalner.se](mailto:erik.nilsson@svalner.se)

### **JENNI PARVIAINEN**

Hannes Snellman Attorneys Ltd.  
*Helsinki, Finland*  
[jenni.parviainen@hannessnellman.com](mailto:jenni.parviainen@hannessnellman.com)

### **LUCA ROSSI**

Facchini Rossi Michelutti  
*Milan, Italy*  
[studio@frstax.it](mailto:studio@frstax.it)

### **STANLEY C. RUCHELMAN**

Ruchelman P.L.L.C.  
*New York, U.S.A.*  
[ruchelman@ruchelaw.com](mailto:ruchelman@ruchelaw.com)

### **MATTHIAS SCHEIFELE**

Hengeler Mueller  
*Munich, Germany*  
[matthias.scheifele@hengeler.com](mailto:matthias.scheifele@hengeler.com)

### **JAMES SOMERVILLE**

A&L Goodbody  
*Dublin, Ireland*  
[jsomerville@algoodbody.com](mailto:jsomerville@algoodbody.com)

### **DR. KARIN SPINDLER-SIMADER**

Wolf Theiss  
*Vienna, Austria*  
[karin-spindler-simader@wolftheiss.com](mailto:karin-spindler-simader@wolftheiss.com)

### **SJOERD STOKMANS**

Van Doorne N.V.  
*Amsterdam, Netherlands*  
[stokmans@vandoorne.com](mailto:stokmans@vandoorne.com)

### **DR. WOLF-GEORG VON RECHENBERG**

BRL Böge Rohde Lübbehusen  
*Berlin, Germany*  
[wolf.vonRechenberg@BRL.de](mailto:wolf.vonRechenberg@BRL.de)

### **ELOISE WALKER**

Pinsent Masons L.L.P.  
*London, U.K.*  
[eloise.walker@pinsentmasons.com](mailto:eloise.walker@pinsentmasons.com)

### **RUTGER ZAAL**

AKD  
*Luxembourg*  
[rzaal@akd.lu](mailto:rzaal@akd.lu)

## ABOUT THE AUTHORS

### JOÃO LUÍS ARAÚJO

João Luís Araújo is a Portuguese tax lawyer and a partner of Telles based in the Porto and Lisbon offices of the firm.

Mr. Araújo has in-depth knowledge of cross border tax issues, derived from counseling clients in large and complex international transactions. In his current position, Mr. Araújo is a primary contact within Telles on matters relating to international groups investing in Portugal and high net worth individuals contemplating a move to Portugal. Before joining Telles, he practiced in London for over 14 years with two of the major accounting firms and a financial institution.

Mr. Araújo is a frequent speaker at conferences addressing legal and tax aspects of investing in Portugal. He is a regular expert commentator on tax matters for news programs in Portugal, international newspapers, and other media.

Mr. Araújo holds an LL.M. in International Taxation, Queen Mary, University of London (2005), is an Affiliate Member of the Association of Taxation Technicians, Chartered Institute of Taxation (2006), and holds an Advanced Diploma in International Taxation (“A.D.I.T.”) issued by the Chartered Institute of Taxation (2007).

### NAIRY DER ARAKELIAN-MERHEJE

Nairy Der Arakelian-Merheje is the Founder and Chair of Der Arakelian-Merheje LLC, where she has practiced in Nicosia for the last 32 years. Her practice concentrates on company, commercial and international business law, including international taxation.

Earlier in her career, Ms. Der Arakelian-Merheje was appointed the first Internal Legal Advisor of Louis Tourist Group, the largest travel and hotel agency in Cyprus. Subsequently, she joined Tassos Papadopoulos & Co., the law office of the former President of the Republic of Cyprus, where she advised international corporate clients and practiced commercial, company, and private international law for seven years. In her current practice, she maintains an international client portfolio.

Ms. Der Arakelian-Merheje has contributed to several publications, including Practising Law Institute, Who’s Who Legal, CorporateINTL, *Competition Laws of Europe on Competition Law Direct* (Maitland Walker), and the I.T.S.G. Global Tax Journal.

Ms. Der Arakelian-Merheje is a member of the Cyprus Bar Association, the European Bar Association, the International Tax Specialist Group, the Avriio-Advocati network of European Lawyers and Rotary International. She is fluent in Greek, English, French, Armenian, and Turkish.

Ms. Der Arakelian-Merheje obtained her law degree from Reading University, England (1979) and passed the Solicitor’s Qualifying Examination of the Law Society of England (1980).

### GUILLERMO CANALEJO LASARTE

Guillermo Canalejo Lasarte is a Spanish lawyer and a member of the Spanish law firm Uría Menéndez. He is currently based in its Madrid office.

Mr. Canalejo has a wide range of experience in corporate tax matters and specializes in cross-border investments and international tax planning, advising both foreign-based and Spanish-based multinationals. He is actively involved in developing tax-efficient financing structures and securitization transactions, advising on the tax aspects of asset and project finance primarily for the transportation and infrastructure sectors. He advises on private equity transactions, collective investment vehicles, and generational wealth tax planning.

Mr. Canalejo is a member of the Madrid bar and a member of the I.B.A. Taxes Committee. He is a frequent speaker and writer on international and Spanish tax issues.

Mr. Canalejo holds a law degree from the Universidad Complutense of Madrid, a B.A. in international business administration from the American University of Paris, and an LL.M. in tax law from C.E.G., Madrid.

## **MICHEL COLLET**

Michel Collet is a partner of CMS Francis Lefebvre, practicing in the firm's international tax group. Mr. Collet advises on mergers and acquisitions and cross-border restructuring, corporate finance projects, and real estate. His group of clients includes multinationals, funds, sovereign funds, financial institutions, and high-net-worth individuals such as artists and athletes, for whom he advises on international tax plans. Michel also assists clients in tax examinations and litigation. He advises the governments of certain territories and countries, including Andorra and Saint Barthélemy.

Mr. Collet is an active member of the American Bar Association (“A.B.A.”), the International Bar Association (“I.B.A.”), the International Fiscal Association (“I.F.A.”) and the Tax Review. He is also the tax expert of the legal committee of the *Association des Fiduciaires de France*. He is a member of the *commission “croissance 2020” – growth 2020* set up by the finance minister which serves as a think tank to develop economic reform proposals to foster growth in France. He served as the co-reporter for France at the 2010 annual I.F.A. Congress, addressing the topic of tax treaties, tax avoidance, and application of anti-avoidance provisions. He regularly contributes articles to *Tax Notes International*, *Euromoney*, and several French publications, including *Les Echos*.

Mr. Collet holds a postgraduate degree in international tax law from the University of Paris XI/HEC. He was a lecturer on international/European taxation and corporate tax at Paris Dauphine University from 1998 to 2000. He speaks French and English.

## **STEFAN P. GAUCI**

Stefan P. Gauci acts as a legal consultant in Malta. His practice covers the fields of corporate law and multi-jurisdictional corporate structures, corporate governance, contractual obligations, employment law, trust law and administration, international transport law including ship and aircraft registration, international tax planning, legislation relating to prevention of money laundering and terrorist financing, securitization, licensing, and compliance matters in relation to investment services legislation.

Dr. Gauci has been an approved person by the Malta Financial Services Authority (“M.F.S.A.”) since 2005 and has throughout these years served as director, company secretary, money laundering reporting officer and compliance officer with a number of different regulated companies licensed by the M.F.S.A. in terms of the Company Service Providers Act, the Trusts and Trustees Act, and the Investment Services Act. Dr. Gauci has also served on the Board of Governors of a non-profit foundation in the educational field on a pro bono basis.

He is an active member of the Malta Chamber of Advocates, the Institute of Financial Services Practitioners, the Malta Institute of Taxation (fellowship), the Malta Institute of Management, the Malta Maritime Lawyers Association, the Malta Association of Compliance Officers (former committee member), the International Compliance Association, and the Malta Union of Teachers.

Dr. Gauci is a frequent speaker at seminars organized by the Malta Institute of Taxation. He has co-authored the “Direct Taxation Manual – the Income Tax Acts” (published by the Malta Institute of Taxation in 2009) and contributed articles to “Law and Practice” (a legal journal published by the Malta Chamber of Advocates). He has contributed to publications by the Practising Law Institute (New York) and Geneva Group International, and was a former contributor of e-books on Taxfax.

Dr. Gauci also has held the post of Visiting Lecturer and Examiner at the University of Malta since 2014.

## **WERNER HEYVAERT**

Werner Heyvaert is a partner of AKD Benelux Lawyers, where he practices in the Belgian Office. His practice involves the tax aspects of domestic and international transactions, including structured and cross-border financings, mergers and acquisitions, local tax counseling, transfer pricing, V.A.T., indirect tax, and tax litigation. Werner has over 35 years of experience and has practiced with several multinational law firms in Brussels, Luxembourg, and New York City.

Among his clients are several mid-size U.S. investment companies, several Belgian family-owned industrial and construction companies, one of the major oil and gas companies, one of the largest semiconductor manufacturers, a German clinical trials company, a listed Belgian real estate investment company, a privately owned life insurance company holding substantial real estate investments

through a majority stake in a listed real estate investment company and substantial solar energy parks in Belgium, and a German group active in industrial and commercial textile cleaning activities. In addition, he has advised a global financial services company and one of the largest pharmaceutical groups in the world on two acquisitions. He also represents several clients before the Belgian tax courts, including a major French automobile maker.

In a major survey conducted by the Flemish business magazine, Trends, he was ranked high on the list of the most sought-after Belgian lawyers. He is the former chairman of the Legal & Tax Committee of B.V.A. (Belgian Venture Capital and Private Equity Association). He is also one of the Vice Chairs of the Legal and Tax Committee of the American Chamber of Commerce in Belgium and the Treasurer of the Belgian Association of Tax Lawyers (BATL). He is an active member of the Belgian branch of the International Fiscal Association, the International Bar Association, and the Foreign Lawyers Forum of the Section of Taxation, American Bar Association.

Mr. Heyvaert received his Bachelor's Degree from Universiteit Antwerpen and a Lic. Lur., Law, Philosophy from KU Leuven.

### **ANDREA HØJGAARD JØRGENSEN**

Andrea Højgaard Jørgensen is a Danish tax advisor and a senior associate of CORIT Advisory in Lyngby, Denmark. Mrs. Højgaard Jørgensen has a solid background in tax law, advising in a broad variety of Danish and international tax matters.

Mrs. Højgaard Jørgensen graduated from Copenhagen Business School in 2021 and holds a Master of Business Administration Commercial Law.

### **PAUL KRAAN**

Paul Kraan is specialized in international taxation, predominantly advising funds, family offices, and corporations on Dutch and international tax aspects of their structures. He has ample experience with fund formation, corporate tax planning, and structuring management participation, as well as transaction work.

Mr. Kraan is a board member of the Netherlands Association of Tax Attorneys ("N.V.A.B.") and S.T.E.P. Benelux. He has litigated a substantial number of tax cases before the Dutch courts.

### **FABIENNE LIMACHER**

Fabienne Limacher is a partner in the tax team of Walder Wyss. She advises companies and private clients in national and international tax matters. Ms. Limacher has extensive experience in corporate taxation, particularly in the area of national and international reorganizations, real estate transactions, cross-border relocations, and M&A and private equity transactions. She is also an expert in tax issues relating to financial and insurance products, structured financing, and C.R.S. and F.A.T.C.A. An additional focus of her practice is advising managers, companies, and start-ups on tax and social security issues regarding employee incentive plans and cross-border employee transfers.

Born in 1986, Ms. Limacher was educated at the University of Bern (MLaw 2010) and the University of Sydney (LL.M. 2018). She was admitted to the bar in 2012 and graduated as a certified tax expert in 2016. She worked as a research assistant for the Institute of Tax Law at the University of Bern and as a trainee with Walder Wyss. In addition, she gained working experience as a trainee at the cantonal court and the public prosecutor's office of Canton Nidwalden. Ms. Limacher regularly publishes and lectures on relevant tax topics.

Ms. Limacher's professional languages are German and English. She also speaks French. She is registered with the Zürich Bar Registry and admitted to practice in all of Switzerland.

## **ERIK NILSSON**

Erik Nilsson is a Swedish tax lawyer and a partner of Svalner Skatt & Transaktion based in Stockholm.

Mr. Nilsson has extensive knowledge of local Swedish and cross-border tax issues, derived from counseling clients in both small and large international transactions and restructurings. As the head of Svalner's international taxation group, Mr. Nilsson is the primary contact within Svalner on matters relating to international groups investing and establishing in Sweden. Further, he works with individuals contemplating a move to or from Sweden.

Mr. Nilsson holds a Master of Laws from the University of Uppsala and a Bachelor of Science in business and economics from the University of Uppsala.

## **JENNI PARVIAINEN**

Jenni Parviainen is an attorney-at-law in the tax team of Hannes Snellman Attorneys Ltd in Helsinki, Finland.

Ms. Parviainen frequently acts as counsel in tax litigation and advance proceedings. She also advises a wide range of clients in diverse domestic and cross-border M&A, real estate, finance, and capital markets transactions.

Ms. Parviainen currently serves as an officer of the Taxes Committee of the International Bar Association as well as in the Tax Committee of the Finnish Chamber of Commerce. She has also served as a committee member of the CFE European Tax Advisors. Ms. Parviainen is a frequent speaker at conferences and university lectures, addressing various topics in the field of tax law, tax litigation, and transactional taxation.

Ms. Parviainen holds an LL.M. degree from the University of Turku (2010) and an M.Sc. (Econ.) degree from the Swedish School of Economics in Helsinki (2013).

## **LUCA ROSSI**

Luca Rossi is one of the founding partners of Facchini Rossi Michelutti, Studio Legale Tributario, a tax advisory firm of more than thirty professionals based in Milan and Rome. He provides tax assistance to domestic and foreign corporate groups, banks, and private equity funds. His areas of expertise include M&A and reorganization transactions, financial taxation, corporate taxation, international taxation, transfer pricing and patent box, management incentive plans, assistance in pre-litigation tax settlement procedures and tax litigation. In particular, he has significant expertise in tax matters regarding the banking sector.

Mr. Rossi is a frequent contributor to tax publications and is a co-author of six treatises regarding specific tax issues, such as derivatives contracts in the balance sheet of banks and other financial institutions, capital gains taxation, and Italian corporate tax reform.

Mr. Rossi is the chairman of the board of auditors of Leonardo S.p.A., Larimart S.p.A. – a Leonardo Company, Athora Italia S.p.A., and Nuova Sorgenia Holding S.p.A.

Mr. Rossi is an expert on the Tax Committee of the Italian Association of Certified Public Accountants - Milan Section. He is also member of the Tax & Legal Committee of A.I.F.I. (the Italian Private Equity Association) and of the International Fiscal Association ("I.F.A."). Since 2022, he has been a member of the Scientific Committee of A.S.S.O.S.I.M. - Financial Markets Intermediaries Association.

He has been appointed for a certain period professor by the Ministry of Economic and Finance (*Scuola Superiore dell'Economia e delle Finanze*) and he has been a member of the O.I.C. Commission for Conformation of Italian Tax Law with International Accounting Principles.

He has been recommended in legal directories such as Chambers Europe and Legal 500.

Mr. Rossi received a degree in Economics at the Bocconi University of Milan. He was admitted to the Association of Chartered Accountants of Lodi in 1992 and he is also an Accountant Auditor since 1997.



## **STANLEY C. RUCHELMAN**

Stanley C. Ruchelman is the Chairman of Ruchelman P.L.L.C., based in New York.

Mr. Ruchelman concentrates his practice in the area of tax planning for privately-held transnational business operations, with an emphasis on intercompany transactions. He represents companies in matters involving the I.R.S. and has counseled corporate clients on transfer pricing issues, worldwide reorganizations, and structuring investment in the United States.

Mr. Ruchelman has authored numerous monographs on international taxation for a variety of publications and treatises published by Warren Gorham & Lamont, Kluwers, BNA, and Tax Notes. In addition, Mr. Ruchelman is a frequent lecturer on international tax matters, having spoken at programs sponsored by Practising Law Institute, New York University Tax Institute, the American Bar Association Tax Section, the International Fiscal Association, the International Bar Association, the Canadian Tax Foundation, the Canadian and U.S. Branches of the Society of Trust and Estate Practitioners (S.T.E.P.), the Dutch Association of Tax Advisers, the Belgian Association of Tax Lawyers, and the International Section of the New York State Bar Association. He served as an adjunct professor in the Graduate Tax Program of New York Law School.

Mr. Ruchelman is a former Chair of the Committee on U.S. Activities of Foreigners and Tax Treaties, Section of Taxation, American Bar Association and the International Tax Committee, Section of International Law and Practice, American Bar Association. He is a past member of the National Council of the International Fiscal Association – U.S.A. Branch. Mr. Ruchelman is a fellow of the American Bar Foundation and of the American College of Tax Counsel. He currently is a Co-Chair of the Taxes Committee of the International Section of the New York State Bar Association.

Mr. Ruchelman received his J.D. Degree with Honors from George Washington University (1972) and an undergraduate degree from Brooklyn College (1968).

## **MATTHIAS SCHEIFELE**

Matthias Scheifele is a partner in the Munich office of Hengeler Mueller. He is a German-qualified lawyer and certified tax consultant (Steuerberater).

His practice focuses on all aspects of corporate taxation and corporate transactions, including mergers and acquisitions, demergers and corporate reconstructions, structured finance, securitizations, and asset finance. He also has considerable experience in advising on tax compliance issues. He is a regular contributor to tax journals and speaks at various conferences on tax issues.

Mr. Scheifele attended Julius-Maximilians-University of Würzburg, where he was awarded a Dr. jur. Degree. He also attended Trinity College of Dublin.

## **JAMES SOMERVILLE**

James Somerville is a partner in the Tax Department of A&L Goodbody LLP's Dublin office. He advises on all aspects of tax law, including structured finance transactions, capital markets issues, investment funds and cross-border financings, mergers and acquisitions, inward investment, group reorganizations, property acquisition, and holding company structures.

Mr. Somerville is a former Chairman of the Foreign Lawyers Forum of the Section on Taxation of the American Bar Association, and of the Taxation Committee of the Irish Law Society. He currently sits on the Main Tax Administration Liaison Committee ("T.A.L.C."), which is the main forum for liaising between practitioners in private practices and the Irish Tax Authority. He contributes regularly to legal and tax publications on matters of Irish and international taxation and speaks frequently on those topics at conferences and seminars. Mr. Somerville is a solicitor and an Associate of the Irish Taxation Institute.

Mr. Somerville holds an LL.B. from Trinity College Dublin. He is admitted to practice as a solicitor of the Law Society of England and Wales and of the Law Society of Ireland.

## **DR. KARIN SPINDLER-SIMADER**

Dr. Karin Spindler-Simader is a consultant in the tax team of Wolf Theiss in Vienna. She is admitted as a tax advisor in Austria. Dr. Spindler-Simader specializes in corporate tax law and tax aspects of reorganizations, international tax planning, and international and European tax law. She is also experienced in providing tax advice on complex international M&A transactions.

Dr. Spindler-Simader has years of experience in leading Austrian tax consulting firms. Prior to working in tax consulting, she was a research and teaching assistant at the Institute for Austrian and International Tax Law at the Vienna University of Economics and Business, where she continues to hold a teaching position.

Dr. Spindler-Simader has authored numerous professional publications, including books on withholding taxes and double tax treaty law, and regularly lectures on tax related topics in Austria and abroad. She has been awarded with several prizes for her academic and professional work, including the European Academic Tax Thesis Award in 2013 and being named Rookie of the Year in 2015 at the Austrian Tax Advisors Awards.

Dr. Spindler-Simader is a member of the International Fiscal Association (“I.F.A.”).

She holds a doctorate in economics and business and a degree in business law and has studied in Vienna, Austin, Berkeley, and Santiago de Chile.

## **SJOERD STOKMANS**

Sjoerd Stokmans is a partner of the Amsterdam office of Van Doorne N.V. where his tax practice is a mix of Dutch and international transactional work and traditional client counseling.

Mr. Stokmans specializes in Dutch and international tax law applied to reorganizations, mergers and acquisitions (both for corporations, private equity, and management), international tax structuring, debt restructuring and acquisition financing, share/bond issues, real estate investments, and partnerships. He represents various Dutch and foreign companies, private equity funds, and other investors. He also frequently acts for management teams in substantial buy-outs.

Mr. Stokmans was admitted to the Amsterdam Bar in 2011. He has been the national reporter for the Netherlands of the tax section of the International Bar Association.

Mr. Stokmans studied at VU University Amsterdam where he obtained his Dutch law and tax law degree in 2010.

## **WOLF-GEORG VON RECHENBERG**

Wolf-Georg von Rechenberg is an attorney at law (1982) and a qualified tax advisor (1986). He practices in the Berlin office of BRL Bøge Rohde Lübbehusen, a multidisciplinary firm of lawyers, tax advisors, and certified accountants. His practice is concentrated on the taxation of mergers and acquisitions and international restructuring projects, with a focus on German, E.U., and international tax law. Prior to joining his current firm, Mr. von Rechenberg chaired the CMS Hasche Sigle Tax Practice Group and was a member of the management team of the CMS International Tax Group.

Mr. von Rechenberg taught restructuring law at the Humboldt-University (Berlin). He has published several books and numerous articles on German and international tax and corporate law. He is a frequent speaker on tax law and corporate law issues at national and international conferences. He is an active member of the I.B.A. Taxes Committee, where he served as an officer for several years.

Mr. von Rechenberg studied law and economics at the Universities of Göttingen, Lausanne (Switzerland) and Freiburg i.Br., where he earned his Doctorate (s.c.l.) in 1984.

## **ELOISE WALKER**

Eloise Walker is a partner of Pinsent Masons, where she practices in the London office. Her practice focuses on corporate tax matters within the U.K. and internationally. Her experience includes domestic and international acquisitions and reconstructions, corporate finance and asset-backed securitizations, joint ventures, and tax planning for onshore and offshore establishments with a focus on multi-jurisdictional structures. She has acted for a wide range of corporate and financial institutions.

Mrs. Walker has authored articles for various top-tier publications and is a previous winner of The Tax Journal's "40 under 40" for 2011-2012. She is a member of the tax consulting editorial board for Lexis®PSL, one of the U.K.'s premier tax lawyer knowledge resource providers, and has been recognized year after year by legal directories as a key individual to the London market with a strong track record in advising clients. In Chambers 2021, she is described as being "recognized for her extensive experience advising on the tax aspects of restructuring and M&A. She also regularly assists clients with securitisations and other capital markets transactions."

Mrs. Walker was graduated from Oxford University with a double first class degree in 1996. Before joining Pinsent Masons LLP in 2008, she worked at Linklaters LLP for ten years. She was admitted to the Roll of Solicitors' of England and Wales in 2000.

## **RUTGER ZAAL**

Rutger Zaal is a partner of AKD. He is a member of the International Tax Practice group of AKD and is based in Luxembourg. He assists clients on international tax matters in a variety of transactions including real estate investments, mergers, acquisitions and financing.

Mr. Zaal's clients include private equity firms, multinationals and asset managers, mainly from North America. His strength is to provide robust solutions for complicated tax matters that arise in international transactions. He is appreciated by his clients for his proactive approach and practical advice.

Mr. Zaal has over 20 years of experience in providing tax advice and tax compliance services. He has worked in Amsterdam, New York, and Luxembourg.

Mr. Zaal is a member of the International Fiscal Association ("I.F.A.") including the U.S. and Canadian branches thereof, the American Bar Association ("A.B.A."), the Canadian Tax Foundation ("C.T.F.") and the Dutch Association of Tax Advisors ("N.O.B."). He is a frequent participant in tax conferences of the organizations of which he is a member.

## CHART: AN OVERVIEW

The following chart is a summary of several of the most common tax regimes that are covered in detail in this text. Below is a brief explanation of what information is shown in each row. For an in-depth discussion of a country's rules, refer to its respective section.

- **Corporate Income Tax (“C.I.T.”); V.A.T.**  
The standard effective rate is shown, with notations.
- **Participation Exemption (“P/E”).**  
Whether a full or partial exemption is provided for dividends and capital gains is shown. For a discussion of minimum requirements, refer to the country's respective section.
- **Dividends Paid.**  
Regarding withholding tax levied on dividends paid by a holding company to a nonresident shareholder, three rates are discussed: the P.S.D. rate, the regular withholding rate, and treaty rates.
- **Dividends Received; Capital Gains.**  
Regarding capital gains and dividends received by a holding company, two rates are shown: the exemption provided under the participation exemption, if applicable, and the regular rate.
- **Double Tax Relief; Tax Treaties.**  
The size of the treaty network and types of relief available are shown.
- **Diverted Profits Tax (“D.P.T.”).**  
Whether this tax is present, and the rate if so, is shown.
- **Debt vs. Equity.**  
The type of regulations is shown – thin capitalization rules or a general limitation on interest payments – as well as the ratio or cap on E.B.I.T.D.A.
- **Capital Tax/Stamp Duty; C.F.C. Rules; Patent Box; Transfer Pricing; G.A.A.R./P.P.T.; Hybrid Mismatch Rules; Exit Tax.**  
Whether regulations are in place is shown.

|  | <b>Austria</b>            | <b>Belgium</b>          | <b>Cyprus</b>                         |
|--|---------------------------|-------------------------|---------------------------------------|
| <b>C.I.T.</b>  | 23%                       | 25%                     | 12.5%                                 |
| <b>Participation Exemption (Dividends/Capital Gains)</b> | Full / Full               | Full / Full             | Full / Full                           |
| <b>Dividends Paid</b>                                    | 0% / 27.5% / treaty rate  | 0% / 30% / treaty rate  | 0%                                    |
| <b>Dividends Received</b>                                | Full / 23%                | Full / 25%              | Generally exempt                      |
| <b>Capital Gains</b>                                     | Full / 23%                | P/E / 25%               | Full / 20%                            |
| <b>Double Tax Relief</b>                                 | D.T.T.; Exempt/Credit     | D.T.T.; Credit          | D.T.T.; Credit                        |
| <b>Tax Treaties</b>                                      | 89                        | 96                      | 67                                    |
| <b>V.A.T.</b>  | 20%                       | 21%                     | 19%                                   |
| <b>Capital Tax / Stamp Duty</b>                          | No / Yes                  | No / Yes                | Yes / Yes                             |
| <b>Diverted Profits Tax</b>                              | No                        | No                      | No                                    |
| <b>C.F.C. Rules</b>                                      | Yes                       | Yes                     | Yes                                   |
| <b>Debt vs. Equity</b>                                   | No formal thin cap. rules | 5:1 / Gen. Limit        | Interest limitation based on A.T.A.D. |
| <b>Transfer Pricing</b>                                  | Based on O.E.C.D. rules   | Based on O.E.C.D. rules | Based on O.E.C.D. rules               |
| <b>Patent Box</b>  | No                        | Yes                     | Yes                                   |
| <b>G.A.A.R. / P.P.T.</b>                                 | Both                      | Both                    | Both                                  |
| <b>Hybrid Mismatch</b>                                   | Yes                       | Yes                     | Yes                                   |
| <b>Exit Tax</b>  | Yes                       | Yes                     | Yes                                   |

|  | <b>Denmark</b>                   | <b>France</b>                   | <b>Finland</b>                         |
|--|----------------------------------|---------------------------------|--|
| <b>C.I.T.</b>  | 22%                              | 25%                             | 20%                                    |
| <b>Participation Exemption (Dividends/Capital Gains)</b> | Full / Full                      | Partial / Partial               | Full / Full                            |
| <b>Dividends Paid</b>                                    | 0% / 15% / 22% / treaty rate     | 0% / C.I.T. rate / treaty rate  | 0% / 20% (30%) / treaty rate           |
| <b>Dividends Received</b>                                | Full / 15.4%                     | 1.42% / C.I.T. rate             | Full / 20%                             |
| <b>Capital Gains</b>                                     | Full / 22%                       | 3.4% / C.I.T. rate              | Full / 20%                             |
| <b>Double Tax Relief</b>                                 | D.T.T.; Credit                   | D.T.T.; Deduction               | D.T.T.; Exemption, Credit              |
| <b>Tax Treaties</b>                                      | 84                               | 120+                            | 80                                     |
| <b>V.A.T.</b>  | 25%                              | 20%                             | 24%                                    |
| <b>Capital Tax / Stamp Duty</b>                          | No / No                          | Yes / Yes                       | No / Yes                               |
| <b>Diverted Profits Tax</b>                              | No                               | No                              | No                                     |
| <b>C.F.C. Rules</b>                                      | Yes                              | Yes                             | Yes                                    |
| <b>Debt vs. Equity</b>                                   | 4:1 / Asset Basis / Tax E.B.I.T. | Gen. limit 1.5:1 Thin-cap ratio | General interest deduction limitations |
| <b>Transfer Pricing</b>                                  | Based on O.E.C.D. rules          | Based on O.E.C.D. rules         | Based on O.E.C.D. rules                |
| <b>Patent Box</b>  | No                               | Yes (nexus approach)            | No                                     |
| <b>G.A.A.R. / P.P.T.</b>                                 | Both                             | Both                            | Both                                   |
| <b>Hybrid Mismatch</b>                                   | Yes                              | Yes                             | Yes                                    |
| <b>Exit Tax</b>  | Yes                              | No                              | Yes                                    |

|  | <b>Germany</b>            | <b>Ireland</b>            | <b>Italy</b>            |
|--|---------------------------|---------------------------|-------------------------|
| <b>C.I.T.</b>  | ~30%                      | 12.5% or 25%              | 24%                     |
| <b>Participation Exemption (Dividends/Capital Gains)</b> | Partial / Partial         | Full / Full               | Partial / Partial       |
| <b>Dividends Paid</b>                                    | 0% / 26.38% / treaty rate | 0% / 25% / treaty rate    | 0% / 26% / treaty rate  |
| <b>Dividends Received</b>                                | 95% / ~30%                | Full / 12.5% or 25%       | 95% Exempt / 24%        |
| <b>Capital Gains</b>                                     | 95% / ~30%                | Full / 33%                | 95% Exempt / 24%        |
| <b>Double Tax Relief</b>                                 | D.T.T.; Credit; Deduction | D.T.T.; Credit; Deduction | D.T.T.; Credit          |
| <b>Tax Treaties</b>                                      | 97                        | 76                        | 104                     |
| <b>V.A.T.</b>  | 19%                       | 23%                       | 22%                     |
| <b>Capital Tax / Stamp Duty</b>                          | No / No                   | No / Yes                  | Yes / Yes               |
| <b>Diverted Profits Tax</b>                              | No                        | No                        | No                      |
| <b>C.F.C. Rules</b>                                      | Yes                       | Yes                       | Yes                     |
| <b>Debt vs. Equity</b>                                   | Gen. limit on interest    | No thin cap. / Gen. limit | Gen. limit on interest  |
| <b>Transfer Pricing</b>                                  | Based on O.E.C.D. rules   | Based on O.E.C.D. rules   | Based on O.E.C.D. rules |
| <b>Patent Box</b>  | No                        | Yes                       | Yes                     |
| <b>G.A.A.R. / P.P.T.</b>                                 | Both                      | Both                      | Both                    |
| <b>Hybrid Mismatch</b>                                   | Yes                       | Yes                       | Yes                     |
| <b>Exit Tax</b>  | Yes                       | Yes                       | Yes                     |

|  | <b>Luxembourg</b>                        | <b>Malta</b>            | <b>Netherlands</b>             |
|--|--|-------------------------|--------------------------------|
| <b>C.I.T.</b>  | 24.94%                                   | 35%                     | 19% / 25.8%<br>(over €200,000) |
| <b>Participation Exemption<br/>(Dividends/Capital Gains)</b> | Full / Full                              | Full / Full             | Full / Full                    |
| <b>Dividends Paid</b>  | 0% / 15% / treaty rate                   | 0% / none / treaty rate | 0% / 15% / treaty rate         |
| <b>Dividends Received</b>                                    | Full / 17%+                              | Full / 35%              | Full / 25.8% / 19%             |
| <b>Capital Gains</b>   | Full / 17%+                              | Full / 35%              | Full / 25.8% / 19%             |
| <b>Double Tax Relief</b>                                     | D.T.T.; Credit; Deduction                | D.T.T.; Credit          | D.T.T.; Credit; Exemption      |
| <b>Tax Treaties</b>  | 85                                       | 81                      | 97                             |
| <b>V.A.T.</b>  | 17%                                      | 18%                     | 21% / 9%                       |
| <b>Capital Tax /<br/>Stamp Duty</b>                          | Yes / Yes                                | Yes / Yes               | No / No                        |
| <b>Diverted Profits Tax</b>                                  | No                                       | No                      | No                             |
| <b>C.F.C. Rules</b>  | Yes                                      | Yes (A.T.A.D.)          | Yes                            |
| <b>Debt vs. Equity</b>                                       | No thin cap. / Gen. limit<br>on interest | Yes (A.T.A.D.)          | No thin cap. / Gen. limit      |
| <b>Transfer Pricing</b>                                      | Based on O.E.C.D. rules                  | Based on O.E.C.D. rules | Based on O.E.C.D. rules        |
| <b>Patent Box</b>  | Yes                                      | Yes                     | Yes                            |
| <b>G.A.A.R. / P.P.T.</b>                                     | Both                                     | Both                    | Both                           |
| <b>Hybrid Mismatch</b>                                       | Yes                                      | Yes                     | Yes                            |
| <b>Exit Tax</b>  | Yes                                      | Yes                     | No                             |



|  | Portugal   | Spain                     | Sweden                    |
|--|--|---------------------------|---------------------------|
| <b>C.I.T.</b>  | 21%  | 25%                       | 20.6%                     |
| <b>Participation Exemption (Dividends/Capital Gains)</b> | Full / Full  | Partial / Partial         | Full / Full               |
| <b>Dividends Paid</b>                                    | 0% / 25% / treaty rate                                 | 0% / 19% / treaty rate    | 0% / 30% / treaty rate    |
| <b>Dividends Received</b>                                | P/E / 25%  | Partial / 25%             | Full / 30%                |
| <b>Capital Gains</b>                                     | P/E / 25%  | Partial / 25%             | Full / 20.6%              |
| <b>Double Tax Relief</b>                                 | 78 Treaties / F.T.C.                                   | D.T.T.; Credit; Exemption | D.T.T.; Credit; Deduction |
| <b>Tax Treaties</b>                                      | 78   | 95                        | 92                        |
| <b>V.A.T.</b>  | 23%  | 21% / 10% / 4%            | 25%                       |
| <b>Capital Tax / Stamp Duty</b>                          | No / Yes   | Yes / Yes                 | No / Yes                  |
| <b>Diverted Profits Tax</b>                              | No   | No                        | No                        |
| <b>C.F.C. Rules</b>                                      | Yes  | Yes                       | Yes                       |
| <b>Debt vs. Equity</b>                                   | Interest Limitation Rule / Notional Interest Deduction | Gen. limit on interest    | No thin cap. rules        |
| <b>Transfer Pricing</b>                                  | Based on O.E.C.D. rules                                | Based on O.E.C.D. rules   | Based on O.E.C.D. rules   |
| <b>Patent Box</b>  | Yes  | Yes                       | No                        |
| <b>G.A.A.R. / P.P.T.</b>                                 | Both   | Both                      | Both                      |
| <b>Hybrid Mismatch</b>                                   | Yes  | Yes                       | Yes                       |
| <b>Exit Tax</b>  | Yes  | Yes                       | Yes                       |

|  | Switzerland               | United Kingdom            |  |
|--|---------------------------|---------------------------|--|
| <b>C.I.T.</b>  | 11.22% to 222.79%         | 25%                       |  |
| <b>Participation Exemption (Dividends/Capital Gains)</b> | Partial / Partial         | Full / Full               |  |
| <b>Dividends Paid</b>                                    | n/a / 35% / treaty rate   | 0% / none / treaty rate   |  |
| <b>Dividends Received</b>                                | P/E / 11.22% to 22.79%    | Full / 25%                |  |
| <b>Capital Gains</b>                                     | P/E / 11.22% to 222.79%   | Full / 25%                |  |
| <b>Double Tax Relief</b>                                 | D.T.T.; Exempt; Deduction | D.T.T.; Credit; Deduction |  |
| <b>Tax Treaties</b>                                      | 110                       | >130                      |  |
| <b>V.A.T.</b>  | 8.1%                      | 20%                       |  |
| <b>Capital Tax / Stamp Duty</b>                          | Yes / Yes                 | No / Yes                  |  |
| <b>Diverted Profits Tax</b>                              | No                        | 31%                       |  |
| <b>C.F.C. Rules</b>                                      | No                        | Yes                       |  |
| <b>Debt vs. Equity</b>                                   | Generally, 70-85% of debt | Gen. limit on interest    |  |
| <b>Transfer Pricing</b>                                  | Based on O.E.C.D. rules   | Based on O.E.C.D. rules   |  |
| <b>Patent Box</b>  | Yes                       | Yes                       |  |
| <b>G.A.A.R. / P.P.T.</b>                                 | Adopted                   | Both                      |  |
| <b>Hybrid Mismatch</b>                                   | Planned                   | Yes                       |  |
| <b>Exit Tax</b>  | Model 2                   | Yes                       |  |

# INTRODUCTION

## Author

Stanley C. Ruchelman  
Ruchelman P.L.L.C.  
New York, U.S.A.

## GLOBAL TAX PLANNING IN A PRE-2018 WORLD

Prior to 2018, widely-used tax plans of U.S.-based multinational groups were designed to achieve three basic goals in connection with European operations: (i) the reduction of European taxes as European profits were generated, (ii) the integration of European tax plans with U.S. tax concepts to prevent Subpart F from applying to intercompany transactions in Europe, and (iii) the reduction of withholding taxes and U.S. tax under Subpart F as profits were distributed through a chain of European companies and then to the global parent in the U.S.

### Reduction of Taxes in Europe

The first goal – the reduction of European taxation on operating profits – often entailed the deconstruction of a business into various affiliated companies, which can be illustrated as follows:

- Group equity for European operations was placed in a holding company that served as an *entrepôt* to Europe.
- Tangible operating assets related to manufacturing or sales were owned by a second company or companies where the facilities or markets were located.
- Financing was provided by a third company where rulings or legislation were favorable.
- Intangible property was owned by a fourth company qualifying as an innovation box company.

If the roadmap was carefully followed, European taxes on operations could be driven down in ways that did not result in immediate U.S. taxation under Subpart F. A simplified version of the plan that was widely used by U.S.-based multinational groups involved the following steps:

- Form an Irish controlled foreign corporation (“TOPCO”) that is managed and controlled in Bermuda
- Have TOPCO enter into a qualified cost sharing agreement with its U.S. parent providing for the emigration of intangible property to TOPCO for exploitation outside the U.S. at an acceptable buy-in payment that could be paid overtime
- Have TOPCO form a Dutch subsidiary (“DCO”) to serve as a licensing company, and an Irish subsidiary (“OPCO”) to carry on active business operations
- Make check-the-box elections for DCO and OPCO so that both are treated as branches of TOPCO

The author acknowledges the contributions of Michael Bennett and Wooyoung Lee, associates at Ruchelman P.L.L.C., regarding recent events in the U.S.

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Have TOPCO license the rights previously obtained under the qualified cost sharing agreement to DCO and have DCO enter a comparable license agreement with OPCO.

The use of check-the-box entities within Europe eliminated Subpart F income from being recognized in the U.S. A functionally comparable arrangement could be obtained for intercompany loans where such loans were required for capital investments. The qualified cost sharing arrangement eliminated the application of Code §367, which otherwise would mandate ongoing income inclusions for the U.S. parent as if it sold the intangible property pursuant to a deferred payment arrangement with the sales price being contingent on future revenue. Any intercompany dividends paid within the group headed by TOPCO were ignored for Subpart F purposes because of the check-the-box elections made by all of TOPCO's subsidiaries. At the same time, deferred taxes were not reported as current period expenses on financial statements prepared by the U.S. parent provided the underlying earnings were permanently invested abroad.

Meanwhile, earnings were funneled up to the European group equity holder and recycled for further expansion within the European group. Intragroup payments typically did not attract withholding tax under the Parent-Subsidiary Directive ("P.S.D.") or the Interest and Royalty Directive ("I.R.D.") of the European Commission ("E.C.").

For other U.S.-based groups – primarily, those companies that regularly received dividend payments from European operations – the use of a holding company could reduce foreign withholding taxes claimed as foreign tax credits by the U.S. parent in many instances. This was true especially where the U.S. did not have an income tax treaty in force with a particular country or the treaty provided for relatively high withholding tax rates on dividends. Nonetheless, sophisticated planning was often required to take full advantage of the foreign tax credit because of various limitations and roadblocks that existed under U.S. tax law.

### **Foreign Tax Credit Planning in the U.S.**

Although the foreign tax credit has often been 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 has been quite different. Only taxes that were imposed on items of "foreign-source taxable income" could be claimed as credits.<sup>1</sup> This rule, known as "the foreign tax credit limitation," was 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.

The foreign tax credit limitation was structured to prevent so-called "cross crediting," under which high taxes on operating income could be used to offset U.S. tax on lightly taxed investment income. For many years, the foreign tax credit limitation was applied separately with regard to eight different categories, or 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 was eased when the number of foreign tax credit baskets was reduced from eight to two: passive and general.

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<sup>1</sup> Section 904(a) of the Internal Revenue Code of 1986, as amended from time to time ("Code").

*“U.S. income tax regulations required expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.”*

Additionally, the foreign tax credit was reduced for dividends received by U.S. citizens and resident individuals from foreign corporations that, in the hands of the recipient, benefited 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) was removed from the numerator and denominator of the foreign tax credit limitation to reflect the reduced U.S. tax rate imposed on those items.<sup>2</sup> This treatment reduced the foreign tax credit limitation when a U.S. citizen or resident individual received both qualifying dividends from a foreign corporation – subject to low tax in the U.S. – and other items of foreign-source income within the same basket – subject to much higher ordinary tax rates. Another reduction in foreign source gains applied when U.S. source losses reduced foreign source gains. The goal of the provision was to eliminate a double benefit for the taxpayer regarding foreign source gains in that fact pattern. The first benefit was use of a domestic loss to reduce the foreign gain when computing taxable income. The second benefit was the elimination of U.S. tax due by reason of the foreign tax credit.<sup>3</sup>

As a result of all the foregoing rules, a U.S.-based group was required to determine (i) the portion of its overall taxable income that was derived from foreign sources, (ii) the portion derived in each “foreign tax credit basket,” and (iii) the portion derived from sources in the U.S. This was not an easy task, and in some respects, the rules did not achieve an equitable result from management’s viewpoint.

### **Allocation and Apportionment Rules for Expenses**

U.S. income tax regulations required expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.<sup>4</sup> The allocation and apportionment procedures set forth in the regulations were exhaustive and tended 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 were allocated and apportioned under a set of rules that allocated interest expense on an asset-based basis to all income of the group.<sup>5</sup> Direct tracing of interest expense to income derived from a particular asset was permitted in only limited circumstances<sup>6</sup> involving qualified nonrecourse indebtedness,<sup>7</sup> certain integrated financial transactions,<sup>8</sup> and certain related controlled foreign corporation (“C.F.C.”) indebtedness.<sup>9</sup> Research and development expenses, stewardship expenses, charitable deductions, and state franchise taxes needed to be allocated and apportioned among the various classes of income reported on a tax return. These rules tended to reduce the amount of foreign-source taxable income in a particular category, and in some cases, eliminated all income in that category altogether.

<sup>2</sup> Code §§1(h)(11)(C)(iv) and 904(b)(2)(B).

<sup>3</sup> Code §904(b)(2)(A).

<sup>4</sup> Treas. Reg. §§1.861-8 through 17.

<sup>5</sup> Treas. Reg. §§1.861-9T(f)(1) and (g).

<sup>6</sup> Treas. Reg. §1.861-10T(a).

<sup>7</sup> Treas. Reg. §1.861-10T(b).

<sup>8</sup> Treas. Reg. §1.861-10T(c).

<sup>9</sup> Treas. Reg. §1.861-10T(e).

The problem was worsened by carryovers of overall foreign loss accounts.<sup>10</sup> These were “off-book” accounts that arose when expenses incurred in a particular prior year that were allocable and apportionable to foreign-source income exceeded the amount of foreign-source gross income for the year. Where that occurred, the loss was carried over to future years and reduced the foreign-source taxable income of the subsequent year when computing the foreign tax credit limitation.

### **Self-Help Through Inversion Transactions**

The pressure that was placed on the full use of the foreign tax credit by U.S.-based groups resulted in several public companies undergoing inversion transactions. In these transactions, shares of the U.S. parent company held by the public were exchanged for comparable shares of a newly formed offshore company to which foreign subsidiaries were eventually transferred. While the share exchange and the transfer of assets arguably were 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) often eliminated actual tax exposure in the U.S. Thereafter, the foreign subsidiaries were owned directly or indirectly by a foreign parent corporation organized in a tax-favored jurisdiction and the foreign tax credit problems disappeared.

This form of “self-help” was attacked in the anti-inversion rules of Code §7874. In some circumstances, Code §7874 imposes tax on inversion gains that cannot be reduced by credits or net operating loss carryforwards.<sup>11</sup> This occurs in the case described below:



- A foreign corporation acquires substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership.
- After the acquisition, at least 60% of the stock of the acquiring entity is held by either (i) former shareholders of the domestic corporation by reason of their holding stock in the domestic corporation or (ii) former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership.
- After the acquisition, the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity was created or organized when compared to the total business activities of the expanded affiliated group.<sup>12</sup>

In other circumstances, the acquiring entity is considered to be a domestic corporation for purposes of U.S. tax law. This occurs when the former shareholders or partners own at least 80% of the stock of the acquiring entity after the transaction.<sup>13</sup>

Broad regulatory authority has been granted to the I.R.S. to carry out the purposes of Code §7874. By 2017, 12 regulations were issued to address situations that appear to be beyond a literal reading of the statute, but are nonetheless deemed to

<sup>10</sup> Code §904(f).

<sup>11</sup> Code §7874(a)(1).

<sup>12</sup> Code §7874(a)(2)(B).

<sup>13</sup> Code §7878(b).

be abusive by the I.R.S. Abuses that have been addressed by the I.R.S. include the following examples:

- Identifying circumstances where the minimum stock ownership requirement ostensibly is not met, but the foreign acquiring corporation holds a significant amount of passive assets, suggesting the existence of an asset-stuffing transaction intended to avoid a trigger for application of the anti-inversion provisions.<sup>14</sup>
- Combining prior acquisitions of U.S. targets by the foreign acquirer when used to bolster a much larger single acquisition of a target.<sup>15</sup>
- Combining prior acquisitions of foreign targets by the foreign acquirer when used to bolster a much larger single acquisition of a target.<sup>16</sup>
- Addressing certain transfers of stock of a foreign acquiring corporation, through a spin-off or otherwise, following an acquisition.
- Identifying the occurrence of certain distributions that are not made in the ordinary course of businesses by the U.S. entity, suggesting an intent to avoid a trigger for application of the anti-inversion provisions.<sup>17</sup>
- Identifying the acquisition by a C.F.C. of obligations of or equity investments in the new foreign parent corporation or certain foreign affiliates suggesting an intent to avoid taxable investments in U.S. property when such investments were taxable in the hands of a U.S. parent corporation.<sup>18</sup>
- Addressing 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 substantially dilutes a U.S. shareholder's interest in those earnings and profits.<sup>19</sup>
- Related-party stock sales subject to Code §304 (which converts a stock sale of controlled stock into a dividend payment) that are intended to remove untaxed foreign earnings and profits of a C.F.C.<sup>20</sup>

In 2016, the Treasury Department adopted updates to the U.S. Model Income Tax Convention (the "2016 U.S. Model"), which serves as the basic document that the U.S. submits when negotiating an income tax treaty. The draft provisions propose, *inter alia*, to reduce the tax benefits that may be enjoyed by an expatriated group

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<sup>14</sup> Treas. Reg. §1.7874-7.

<sup>15</sup> Treas. Reg. §1.7874-8.

<sup>16</sup> Treas. Reg. §1.7874-9.

<sup>17</sup> Treas. Reg. §1.7874-10.

<sup>18</sup> Treas. Reg. §1.7874-11. The adoption of Code §245A eliminates the taxable event that otherwise exists for an investment in U.S. property in the context of a U.S. corporation owning 10% or more of the shares of a foreign corporation. See Treas. Reg. §1.956-1(a)(2).

<sup>19</sup> Treas. Reg. §1.7874-12.

<sup>20</sup> Treas. Reg. §1.304-7T.

by imposing full withholding taxes on key payments such as dividends,<sup>21</sup> interest,<sup>22</sup> and royalties<sup>23</sup> made to connected persons that are residents of a treaty country by “expatriated entities” as defined under the Code. This treatment lasts for ten years and goes to the heart of the bargain between the U.S. and its treaty partners where the full U.S. withholding tax reduces the tax in the country of the recipient or the dividend is not taxable in the treaty partner country under a participation exemption.

## GLOBAL TAX PLANNING IN A POST-2017 WORLD

The year 2017 sounded the death knell for cross-border tax planning carried on in the old-fashioned way.

By the end of 2017, too many barriers were in place to continue on with established planning strategies. First in line were the actions taken by the Organization for Economic Cooperation and Development (“O.E.C.D.”) to curtail base erosion and profit shifting through adoption of the B.E.P.S. Project. Second, a never-ending package of directives issued by the European Commission and proposals by the European Parliament were designed to attack various tax plans in various ways, including all of the following measures:

- The Anti-Tax Abuse Directives (“A.T.A.D. 1,” “A.T.A.D. 2,” and most recently A.T.A.D. 3”)
- The disclosure and dissemination of tax rulings
- The institution of ownership registers that will disclose the ultimate beneficial ownership of entities
- The mandatory reporting of aggressive tax planning under Council Directive (E.U.) 2018/822 amending Directive 2011/16/E.U. (“D.A.C.6”)
- Limitations placed on the P.S.D. and the I.R.D. to block their application within a European group owned by a non-European parent company

At the same time, tax plans that were previously approved by tax administrations were characterized as a form of unlawful State Aid, triggering severe repayment obligations from benefiting companies.

### **European Attacks on Cross-Border Holding Companies and Tax Planning**

Attacks on tax planning for cross-border holding companies have taken three approaches. The first is based on economic substance. The second is based on E.C. Directives. The third is based on transposition of the B.E.P.S. Actions into national law throughout Europe.

#### **Attacks Based on Economic Substance**

Tax benefits claimed by holding companies in Europe are now regularly challenged by the tax authorities of European countries in which companies making payment are resident. The challenges are directed at the substance of the holding company.

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<sup>21</sup> Paragraph 5 of Article 10 (Dividends) of the 2016 U.S. Model.

<sup>22</sup> *Id.*, ¶2(d) of Article 11 (Interest).

<sup>23</sup> *Id.*, ¶2 of Article 12 (Royalties).



Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management involved in day-to-day decision-making.<sup>24</sup> In some instances, the capital structure of the holding company is queried. Most recently, the European Commission published a proposal for a Directive laying down rules to prevent the misuse of shell entities for improper tax purposes.<sup>25</sup>

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 just 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 typically provided under which substance is judged to exist. In addition, ongoing 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 partnership that has active business operations. These provisions eliminate intra-European challenges of tax authorities and may incentivize direct investment.

### ***Attacks Based on the B.E.P.S. Action Plan***

Substance is also a key concern in the Final B.E.P.S. Package for Reform of the International Tax System to Tackle Tax Avoidance published by the O.E.C.D. The reports were commissioned by the G-20 and reflect findings that a disparity often exists between (i) the location of actual business activities and investment and (ii) the jurisdiction where the resulting profits are reported for tax purposes.

The reports set 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. They also emphasize how changes in global business practices are ahead of current international tax standards, with a special focus on intangibles and the digital economy. The reports identify (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. These include the following key areas:

- International mismatches in entity and instrument characterization
- The application of treaty concepts to profits derived from the delivery of digital goods and services
- The tax treatment of related party debt-financing



<sup>24</sup> A series of cases decided by the Court of Justice of the European Union (“C.J.E.U.”) reflect the approach of the U.S. Tax Court in *Aiken Industries, Inc. v. Commr.*, 56 T.C. 925 (1971), and the I.R.S. in Rev. Rul. 84-152 and Rev. Rul. 84-153 and ultimately Treas. Reg. §1.881-3. See *N Luxembourg 1 v. Skatteministeriet*, Joined Cases C-115, C-118, C-119 & C-299/16, [2019] ECLI:EU:C:2019:134; *Skatteministeriet v. T Danmark und Y Denmark Aps*, Joined Cases C-116/16 & C-117/16, [2019] ECLI:EU:C:2019:135.

<sup>25</sup> The Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/E.U. The proposal was issued on December 22, 2021.

- Captive insurance and other intragroup financial transactions
- Certain aspects of generally recognized transfer pricing rules
- The effectiveness of anti-avoidance measures
- The availability of harmful preferential regimes

The reports adopt a set of comprehensive, global, internationally coordinated action plans 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. Their fears have been justified.

In 2021, the O.E.C.D. proposed Pillar One and Pillar Two. According to the O.E.C.D., Pillar One reallocates the profits of about 100 of the world's largest and most profitable multinational enterprises to market jurisdictions. For a targeted company, Pillar One expands the taxing rights of market jurisdictions to collect tax from the targeted enterprise, regardless of physical presence. Not covered by Pillar One are companies in the extractives sector, such as oil, gas, and mining companies. Also excluded are regulated companies operating in the financial services sector.

Pillar Two is designed to ensure that a multinational enterprise pays a minimum level of tax, regardless of the location of its headquarters or the jurisdictions in which it operates. Pillar Two is thought to target approximately 2,000 multinational corporations and is expected to raise about \$150 billion in additional global tax revenue annually. Consequently, those persons who invest directly or indirectly in companies that are targeted will be adversely affected. Pillar Two establishes a global minimum effective tax rate of 15%. It applies to multinational groups with consolidated group revenue of at least €750 million. Countries may elect to adopt a lower threshold for application. Under the Pillar Two income inclusion rule ("I.I.R."), a "top-up" tax to the 15% global minimum rate is imposed on the parent of the group by its country of residence if a member tries to shift profits to low-tax or no-tax jurisdictions. If the tax is not collected by the ultimate parent in a chain of ownership, the jurisdiction of residence of the next lower company in the chain may impose the tax, and so on until the I.I.R. amount is fully collected. Pillar Two also includes an under-taxed payments rule ("U.T.P.R."), under which a deduction for undertaxed cross-border payments is disallowed for the company making the payment. Alternatively, that country may impose a withholding tax on the payment. Note that a payment to a company that triggers the application of the I.I.R. for its ultimate parent does not prevent the U.T.P.R. rule from applying in the jurisdiction of the company making the payment.

While the B.E.P.S. Reports have no legal authority, they reflect a political consensus in Europe and elsewhere regarding steps to be taken to shut down transactions that are perceived to be abusive. Consequently, the B.E.P.S. Reports must be considered before setting up a foreign holding company in Europe. To illustrate, the Council of Economic and Finance Ministers ("E.C.O.F.I.N.") has recommended changes in the P.S.D. designed to eliminate the exemption enjoyed by parent companies for dividends paid by subsidiaries when the subsidiary claims a deduction for the payment. E.U. Member States implemented the change to the P.S.D. in 2016.<sup>26</sup>

<sup>26</sup> See also the Danish Cases discussed at note 24, where the C.J.E.U. adopted B.E.P.S. concepts as part of European Law.

*“In 2021, the O.E.C.D. proposed Pillar One and Pillar Two. According to the O.E.C.D., Pillar One reallocates the profits of about 100 of the world’s largest and most profitable multinational enterprises to market jurisdictions.”*

The B.E.P.S. Reports reflect a view that is now accepted by tax authorities throughout Europe. Taxation should not be viewed as an expense. Rather, it reflects a profit-sharing arrangement between governments and businesses, akin to the interest of limited partners in a limited partnership. The multinational enterprise is looked at as if it is the general partner and governments are looked at as limited partners. Viewed in this light, schemes with no substance cannot be allowed to deprive the governments of their “profit share.” Such a scheme does not reflect good tax planning; rather, it is viewed as theft, plain and simple. In what is known as the Cum-Ex scandal,<sup>27</sup> Denmark is actively pursuing civil claims against facilitators of a specific tax refund arrangement that took advantage of flawed withholding tax rules for dividend payments by Danish companies. The defendants are individuals, professional firms, and advisers, based mostly in the U.S. and the U.K. It is reported that Denmark has budgeted \$380 million for legal costs to pursue its targets.

### Attacks Based on State Aid

Cross-border tax planning within the E.U. has faced challenges based on concepts of State Aid, transparency, and the Common Reporting Standard. Until recently, tax planning was not viewed to be an item of unfair State Aid violating basic rules of the E.U. That has changed. In its place is a mechanism calling for information reporting designed to promote pan-European information exchange, both as to bank balances and “sweetheart” tax rulings.

Following the O.E.C.D. B.E.P.S. Reports, the European Commission introduced an anti-tax avoidance directive (*i.e.*, the A.T.A.D. 1). It was adopted on June 20, 2016, and contains anti-tax avoidance rules in five specific fields:

- Exit taxation
- Interest deduction limitation
- C.F.C. rules
- The general anti-abuse rule (“G.A.A.R.”)
- Hybrid mismatches

The rules are in addition to the changes to the P.S.D. (regarding G.A.A.R. and anti-hybrid financing rules) and may be followed by a relaunched proposal on the Common Corporate Tax Base (“C.C.T.B.”) and the Common Consolidated Corporate Tax Base (“C.C.C.T.B.”).

On February 21, 2017, the E.U. Member States agreed on an amendment to the A.T.A.D. 1 (*i.e.*, the A.T.A.D. 2), which provides detailed rules targeting various hybrid mismatches between Member States and countries outside the E.U. The following mismatches are included:

- Hybrid financial instrument mismatches
- Hybrid entity mismatches

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<sup>27</sup> See Sunita Doobay and Stanley C. Ruchelman, *Adventures in Cross-Border Tax Collection: Revenue Rule vs. Cum-Ex Litigation*, Tax Notes International, April 18, 2022, cover and pp. 329-372 and Tax Notes Federal, April 18, 2022, pp. 359-403.

- Reverse hybrid mismatches
- Hybrid transfers
- Hybrid permanent establishment mismatches
- Dual resident mismatches

### **Revisions to U.S. Tax Rules Affecting Global Business**

If these were not sufficient impediments to old-fashioned tax plans, the United States enacted the Tax Cuts & Jobs Act (“T.C.J.A.”)<sup>28</sup> in late December 2017. Among other things, the T.C.J.A. revised U.S. law as follows:

- The corporate tax rates were reduced to 21%.
- The scope of the C.F.C. rules were expanded.
- The deemed paid foreign tax credit rules in connection with direct investment dividends received by corporations were replaced by an intercompany dividend received deduction (“D.R.D.”) applicable to dividends received from 10%-owned foreign subsidiaries.
- Deductions are allowed for the use of foreign-derived intangible income generated by U.S. businesses from operations in the U.S. that service foreign markets.
- Deferral of earnings of a C.F.C. that are derived from the use of intangible property is eliminated.
- Nonrecognition treatment for transfers of business assets to a foreign subsidiary has been eliminated.
- The transfer pricing statute (Code §482) has been amended to increase the income that is deemed to be realized from a transfer of ownership or use of intangible property to a foreign corporation.
- The opportunity to use of hybrid payments of interest and royalties to reduce Subpart F income of C.F.C.’s and taxable income foreign-controlled U.S. companies has been eliminated.
- A Base Erosion and Anti-Abuse Tax (“B.E.A.T.”) has been imposed on large U.S. companies and U.S. branches of foreign companies in connection in order to reduce the tax benefit arising from deductible payments to foreign related parties.

### **Broadened Scope of Subpart F**

Subpart F of the Code is applicable to C.F.C.’s and their “U.S. Shareholders,” as defined below. It is a principal anti-deferral regime with relevance to a U.S.-based multinational corporate group. A C.F.C. generally is defined as any foreign corporation

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<sup>28</sup> *An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018*, Public Law 115-97, U.S. Statutes at Large 131 (2017): 2054-2238.

in which “U.S. Shareholders” own (directly, indirectly, or constructively) shares representing more than 50% of the corporation’s voting power or value.

Certain rules of attribution apply to treat shares owned by one person as if owned by another. Shares may be attributed between individuals, corporations, partnerships, trusts, and estates. Consequently, the ownership of a taxpayer’s shares in one company could be attributed to another company owned by the same taxpayer for the purposes of determining, *inter alia*, whether the second company is a U.S. Shareholder of a C.F.C. and whether two companies are related because one controls the other or both are under common control. Although ownership of shares is attributed from one person to another for the foregoing purposes, that attribution does not cause the latter person to be taxed under Subpart F on the income of the C.F.C. In other words, income follows legal ownership.

Under prior law, a “U.S. Shareholder” was a U.S. person that owned shares of the foreign corporation having 10% or more of the voting power of all shares issued by the corporation. For this purpose, U.S. persons include U.S. citizens, U.S. residents, U.S. corporations, U.S. domestic trusts or estates, and U.S. partnerships and L.L.C.’s. In applying the attribution rules, shares could not be attributed from a foreign corporation to a U.S. corporation in which shares representing more than 50% of the voting power or value were owned in the U.S. corporation. In addition, before Subpart F could apply to a C.F.C. and its U.S. Shareholders, a foreign corporation was required to be a C.F.C. for at least 30 days during the taxable year.

The T.C.J.A. made several changes to the provisions of Subpart F. First, the definition of a U.S. Shareholder was expanded so that a person is a U.S. Shareholder of a foreign corporation if shares are owned in the foreign corporation and those shares represent at least 10% of the voting power *or the value* of the foreign corporation.

Second, if more than 50% of the shares in a U.S. subsidiary are owned by a foreign parent, the U.S. subsidiary constructively owns shares in all non-U.S. corporations that are actually owned by the foreign parent for the purposes discussed above. As a result, foreign-based groups with members in many countries, including the U.S., may find that all members based outside the U.S. are at risk of becoming C.F.C.’s for certain U.S. tax purposes, with the U.S. affiliate treated as if it were the parent company of the group. This can broaden the scope of information reporting, but not the imposition of tax within the group. However, it can affect unrelated U.S. persons owning 10% or more of the shares of a foreign corporation, causing such U.S. persons to pay tax immediately on its share of any Subpart F income of the newly categorized C.F.C. In essence, this rule attacks certain joint ventures abroad consisting of U.S. businesses and members of a foreign multinational group with subsidiaries in the U.S.

In 2018, the I.R.S. announced that it would not impose a reporting obligation on the U.S. entity in these circumstances, provided that no U.S. entity owns stock in such C.F.C., either directly or indirectly through a foreign subsidiary, and the foreign corporation is a C.F.C. solely because a U.S. entity constructively owns stock in the corporation through a foreign parent. This rule helped foreign based groups having members in the U.S. but not when U.S. persons co-invest directly or indirectly in a foreign joint venture company.

Finally, a foreign corporation is no longer required to be a C.F.C. for 30 days in order for Subpart F to apply to its U.S. Shareholders. This provision affects many



tax plans put in place for high net worth individuals with children who live in the U.S. Those plans typically involved the use of foreign blocker corporations that protected U.S. situs investment assets from the imposition of U.S. estate taxes for a non-U.S. parent. At the same time, the plans allowed the children to have a tax-free step-up in cost basis in the investment assets if the foreign blocker is liquidated promptly after the parent's death.

### Cross-Border Intercompany Dividends Received Deduction

Generally, U.S. citizens, residents, and domestic corporations are considered to be U.S. persons subject to tax on worldwide income. To eliminate double taxation of income, the U.S. allows a credit for foreign income taxes paid on foreign-source income. For taxpayers that are corporations, an indirect credit was allowed under prior law for foreign income taxes paid by foreign corporations when the U.S. corporation owned shares in a foreign corporation representing 10% or more of the voting power. Under the indirect foreign tax credit computations, a U.S. Shareholder of a C.F.C. kept track of the pool of the post-1986 earnings of the C.F.C. and the pool of foreign income taxes associated with those earnings. Foreign income taxes associated with post-1986 earnings were deemed paid on a proportional basis as the earnings in that pool were distributed. The indirect foreign tax credit reached down to the sixth level of foreign subsidiary, so long as the U.S. corporation indirectly owned at least 5% of the lower tier subsidiaries.

The T.C.J.A. abandons the indirect foreign tax credit and moves to a D.R.D. system.<sup>29</sup> A 100% deduction is allowed for the foreign-source portion of dividends received from 10%-owned foreign corporations. To be entitled to the D.R.D., a U.S. corporation must hold its 10% interest for more than 365 days in the 731-day period beginning on the date that is 365 days before the ex-dividend date in the declaration.

The D.R.D. is not available for hybrid dividends. These are amounts for which a deduction would be allowed under the D.R.D. rules except that the specified 10%-owned foreign corporation has already received a deduction or other tax benefit in any foreign country. Also, if a C.F.C. with respect to which a domestic corporation is a U.S. Shareholder receives a hybrid dividend from a related C.F.C., the hybrid dividend is treated as Subpart F income of the recipient C.F.C.<sup>30</sup> None of the exceptions to taxation under Subpart F are applicable.

The indirect foreign tax credit remains in effect to eliminate double taxation for U.S. corporations that are taxed under Subpart F in connection with foreign subsidiaries that are C.F.C.'s. However, the indirect foreign tax credit is not applicable to a hybrid dividend that gives rise to an income inclusion for a U.S. corporation that is a U.S. Shareholder.<sup>31</sup>

There is no equivalent to the D.R.D. for repatriations from a foreign branch. Income from foreign branches is taxed immediately and the taxpayer may claim a direct foreign tax credit for foreign income taxes paid. Foreign branch income is placed in a separate foreign tax credit limitation basket.<sup>32</sup>

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<sup>29</sup> Code §245A.

<sup>30</sup> Code §245A(e)(2).

<sup>31</sup> Code §245A(e)(3).

<sup>32</sup> Code §904(d)(1)(B).

### One-Time Transition Tax Accompanies Transition to D.R.D.

In order to create a level playing field for all earnings accumulated abroad in C.F.C.'s and other non-U.S. corporations in which a U.S. corporation owns sufficient shares to claim an indirect foreign tax credit, all post-1986 earnings of such foreign corporations are deemed to be distributed on the last day of the taxable year beginning prior to January 1, 2018.<sup>33</sup>

If the foreign corporation is a C.F.C., all U.S. Shareholders as defined under prior law report the income. If the foreign corporation is not a C.F.C., only 10% shareholders report the income, provided that at least one such shareholder is a U.S. corporation.<sup>34</sup>

The rate of U.S. tax on the amount included in income is reduced by means of a notional deduction.<sup>35</sup> For U.S. corporations, the rate is 15.5% to the extent that the earnings have been invested in cash or cash equivalents, based on the balance sheet of the C.F.C. The balance of the earnings is taxed at a rate of 8%. The rate for individuals is assumed to be marginally higher.

Corporations may claim an indirect foreign tax credit for foreign income taxes paid by the C.F.C. in connection with the post-1986 pool of earnings. However, the pool of foreign income taxes is reduced to reflect the reduction in the tax rate of the U.S. Shareholder.<sup>36</sup>

At the election of the taxpayer, the total tax is computed on the tax return for 2017, but the taxpayer can also elect to pay the tax in eight annual installments, so that 40% of the total tax is paid in equal installments over the first five years and the balance is paid in escalating installments over the last three years.<sup>37</sup>

For individual taxpayers who missed the April 18, 2018, deadline for making the first of the eight annual installment payments, the I.R.S. will waive the late-payment penalty if the installment is paid in full by April 15, 2019.<sup>38</sup> Absent this relief, a taxpayer's remaining installments over the eight-year period would have become due immediately. This relief is only available if the individual's total transition tax liability is less than \$1 million.

The validity of the transition tax was upheld in *Moore v. U.S.*, 602 U. S. \_\_\_ (2024). In *Moore*, the taxpayers were investors in an Indian corporation. They owned at least 10% of the issued and outstanding shares of the corporation on the effective date of the tax. They paid transition tax in the amount of \$14,729, after which they sued for a refund. In their view, the transition tax was an unconstitutional tax because it was not based on currently realized income. As such, the taxpayers contended the tax

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<sup>33</sup> Code §965.

<sup>34</sup> Code §965(e).

<sup>35</sup> Code §965(c).

<sup>36</sup> Code §965(g).

<sup>37</sup> Code §965(h).

<sup>38</sup> IR-2018-131 issued on June 4, 2018, announcing three additions to the I.R.S. Frequently Asked Questions on the transition tax.

was a direct tax on property, which under the U.S. Constitution must be apportioned to each state based on the state's share of the total population of the nation. They further argued that the retroactive nature of the tax violated due process. Retained earnings as far back as 2006 were taxed.

Part of the reason for the attention surrounding the case was that a successful challenge could upend the entire C.F.C. regime, which depends on taxing U.S. shareholders of C.F.C.'s on their respective interests in the C.F.C. profits.

The Supreme Court rejected the arguments of the taxpayers and found that the tax was an income tax because income was realized at some point by the C.F.C. Congress has the power to determine whether the corporation generating the income or its shareholders should be taxed. The Supreme Court analogized to principles of partnership taxation, S-corporation taxation, and the rest of the C.F.C. regime, to conclude that the tax was an income tax and not a property tax.

### *U.S. Reduced Tax Rate Imposed on Global Intangible Low-Tax Income of C.F.C.'s*

The T.C.J.A. enacts a global intangible low-taxed income ("G.I.L.T.I.") regime that is designed to decrease the incentive for a U.S.-based multinational groups to shift corporate profits to controlled subsidiaries based in low-tax jurisdictions.<sup>39</sup>

#### Computation of Tested Income Under the G.I.L.T.I. Regime

The G.I.L.T.I. regime applies to U.S. Shareholders of C.F.C.'s, as defined above. G.I.L.T.I. applies only to income that is not already taxed in the U.S. either at the level of a C.F.C. or its U.S. Shareholders. Consequently, it is an add-on tax imposed on profits that would have benefited from deferral under prior law.

The first step in computing G.I.L.T.I. is to eliminate the C.F.C.'s items of income that produce current tax.<sup>40</sup> These include the following items of income:

- Business income that is subject to net-basis taxation in the U.S.
- Dividends from a related C.F.C. that are not subject to tax in the U.S. at either the level of the C.F.C. or the level of its U.S. Shareholders because of Subpart F
- All other income of a C.F.C. that results in an immediate U.S. tax under Subpart F for its U.S. Shareholders

The remaining income is referred to as "Tested Income."

#### Removal of Qualified Business Asset Income

In determining how much Tested Income is treated as G.I.L.T.I., actual economic drivers for generating income are ignored. Instead, all items of C.F.C. income are deemed to arise from either depreciable tangible property used in the business or intangible property used in the business.<sup>41</sup> Consequently, investment in inventory, work in progress, and supplies are lumped into the intangible category because

<sup>39</sup> Code §951A.

<sup>40</sup> Code §951A(c)(2)(A)(i).

<sup>41</sup> Code §951A(b)(1).

***"The Supreme Court rejected the arguments of the taxpayers and found that the tax was an income tax because income was realized at some point by the C.F.C."***



they fail to meet the definition of depreciable tangible property. Similar treatment is provided for the financial assets of a bank that is a C.F.C.

The investment in tangible depreciable property is deemed to generate a 10% yield computed with reference to the adjusted basis of the property.<sup>42</sup> The amount so determined is reduced by interest expense allocated against the tangible depreciable property.<sup>43</sup> The balance of the income is attributable to intangible property, which in turn gives rise to G.I.L.T.I. for U.S. Shareholders of a C.F.C.

### Netting of Tested Income

At this point, the positive and negative G.I.L.T.I. results for each C.F.C. owned by the same U.S. Shareholder are aggregated. The U.S. Shareholder reports the net amount of G.I.L.T.I. on its U.S. Federal tax return. The aggregate amount is then allocated to each C.F.C. with positive Tested Income.

### Foreign Tax Credit Computations

When a U.S. Shareholder is a corporation, several additional computations are required:

- First, a deemed foreign tax credit is allowed for foreign income taxes attributable to G.I.L.T.I.<sup>44</sup> The starting point in determining those taxes is to identify the C.F.C.'s total foreign income taxes paid.
- Second, the foreign income taxes attributable to income not included in Tested Income are removed. Again, these are foreign income taxes attributable to Subpart F Income of the C.F.C. or income arising from a business conducted in the U.S. What remains are "Tested Foreign Tax Credits."
- Third, the portion of the total Tested Foreign Tax Credits that are attributable to the 10% yield on depreciable tangible property must be identified and removed from the pool. What remains are Tested Foreign Tax Credits attributable to G.I.L.T.I.

Because the foreign tax credit in this scenario relates to taxes actually paid by the C.F.C. but attributed to the corporate U.S. Shareholder – sometimes called a deemed-paid or indirect credit – the taxes for which the credit is claimed must be added to the amount otherwise reported as taxable. This is referred to as a gross-up.<sup>45</sup> Its purpose is to equate the deemed-paid credit to a direct foreign tax credit of a branch of the U.S. corporation. There, the payment of the creditable tax does not reduce taxable income – just as the Federal income tax does not reduce U.S. taxable income.

The foreign income taxes attributable to G.I.L.T.I. are placed in a separate foreign tax credit limitation basket. The separate basket ring-fences the income and creditable taxes so that the U.S. tax on G.I.L.T.I. cannot be offset by excessive taxes on income in other baskets. The amount of foreign taxes creditable to G.I.L.T.I. is then multiplied by an inclusion percentage (discussed below) and reduced by 20% so

<sup>42</sup> Code §951(b)(2)(A).

<sup>43</sup> Code §951(b)(2)(B).

<sup>44</sup> Code §960(d).

<sup>45</sup> Code §78.

that only 80% of available foreign tax credits attributable to G.I.L.T.I. are ultimately creditable.<sup>46</sup> This reduction has no effect on the gross-up under Code §78.

The inclusion percentage reflects the fact that the G.I.L.T.I. inclusion is determined by netting profitable G.I.L.T.I. operations of C.F.C.'s owned by the corporate U.S. Shareholder with unprofitable operations. Again, profitable operations and unprofitable operations are determined on an after-tax basis at the level of the C.F.C. The pool of available foreign tax credits must then be reduced to reflect the benefit of the netting computation. Consequently, the inclusion percentage is determined by dividing (i) the net G.I.L.T.I. inclusion reported by the corporate U.S. Shareholder by (ii) the gross Tested Income of all C.F.C.'s having positive Tested Income. Only foreign income taxes paid by subsidiaries that report positive G.I.L.T.I. may be claimed as an indirect foreign tax credit.

The foreign tax credit limitation is computed based on a 21% corporate income tax. To the extent foreign income tax on Tested Income tax cannot be credited by the corporate U.S. Shareholder in the year of the G.I.L.T.I. inclusion, the tax is lost forever. No carryback or carryforward is provided for unused G.I.L.T.I.-related foreign tax credits. Consequently, the lost taxes reflect each of the following computations:

- Application of 80% cap on the pool of available foreign taxes
- Foreign income taxes imposed on a C.F.C. that reports negative Tested Income on an after-tax basis
- Foreign income taxes in excess of the foreign tax credit limitation based on the 21% corporate tax rate in the U.S.

### 50% Deduction for Corporate U.S. Shareholders

Once the gross amount of G.I.L.T.I. is determined, a U.S. Shareholder that is a corporation is entitled to a 50% deduction based on the amount of G.I.L.T.I. included in income.<sup>47</sup> Because the rate of corporate tax in the U.S. is 21%, a corporate U.S. Shareholder's effective tax rate on G.I.L.T.I. will be 10.5%. If foreign taxes are available to be claimed as a credit, the effective rate of tax must take into account the 20% of deemed paid taxes that are not available for any credit. This makes the effective rate of U.S. tax 13.125%.

The deduction is not available to individuals. However, individuals may elect to create a silo of income and taxes with regard to G.I.L.T.I. Income in the silo can be taxed as if earned by a corporation.<sup>48</sup> The income in the silo is entitled to the 50% deduction,<sup>49</sup> as the legislative history of the T.C.J.A. describes the deduction as a "reduced rates" mechanism.<sup>50</sup> This characterization is important because an indi-

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<sup>46</sup> Code §960(d)(1).

<sup>47</sup> Code §250.

<sup>48</sup> Code §962.

<sup>49</sup> Prop Treas. Reg §1.962-1(b)(3).

<sup>50</sup> See U.S. Congress, House of Representatives, Committee of Conference, *Conference Report on H.R. 1, Tax Cuts and Jobs Act*, 115th Cong., 1st sess., 2017, H. Rep. 115-466 at note 1515. See also note 1516, referring to the deduction as a method to reduce corporate tax rates.

vidual making the election to be taxed at corporate rates generally is not entitled to deductions, except as allowed in the provision allowing for the election.

**Foreign-Derived Intangible Income Deduction for Domestic Operating Income of U.S. Companies Related to the Exploitation of Foreign Markets**

At the same time the T.C.J.A. accelerated tax under the G.I.L.T.I. regime for certain profits derived abroad from active business operations, it also provided a deduction for U.S. corporations operating in the U.S. to expand sales of products and services abroad.<sup>51</sup> The deduction relates to foreign-derived intangible income (“F.D.I.I.”) and shares many of the technical concepts of the G.I.L.T.I. regime, albeit in the context of exports.

F.D.I.I. is the portion of a U.S. corporation’s intangible income derived from serving foreign markets, determined by a formula. The F.D.I.I. of any U.S. corporation is the amount that bears the same ratio to the “deemed intangible income” of the corporation as its “foreign-derived deduction eligible income” bears to its “deduction eligible income.”

Several new terms must be understood to compute the F.D.I.I. deduction:

- “Deemed intangible income” means all deduction eligible income in excess of “deemed tangible income” return.
- “Deemed tangible income” means a 10% return on the average basis in depreciable tangible property used in a trade or business and of a type for which a depreciation deduction is allowed.
- “Deduction eligible income” means, with respect to any U.S. corporation, the amount by which (i) gross income (excluding certain income items taxed in connection with operations conducted outside the U.S. directly or through a C.F.C.) exceeds (ii) allocable deductions (including taxes).
- “Foreign-derived deduction eligible income,” means deduction eligible income derived in connection with property that is sold by the taxpayer to any person who is not a U.S. person. The sale must be made for use, consumption, or disposition outside the U.S. by the purchaser. If services, they must be provided by the taxpayer to any person not located in the U.S. or with respect to property not located in the U.S. The I.R.S. is given broad discretion in determining whether the taxpayer has met its burden of proof in establishing that property has been sold for use outside the U.S. or services have been performed for persons or with regard to property located outside the U.S.
- The terms “sold,” “sells,” and “sale” include any lease, license, exchange, or other disposition. “Foreign use” means any use, consumption, or disposition outside the U.S.

A U.S. corporation may claim a 37.5% deduction for the foreign-derived deduction eligible income when computing taxable income. The intent is to impose a 13.125% rate of tax on these profits.<sup>52</sup> This deduction is not available to individuals who operate a business through a limited liability company.

<sup>51</sup> Code §250.

<sup>52</sup> Code §250(a)(1)(A).

**“A U.S. corporation may claim a 37.5% deduction for the foreign-derived deduction eligible income when computing taxable income.”**

### Base Erosion and Anti-Abuse Tax

The T.C.J.A. introduced a minimum tax provision for large corporations that significantly reduce their U.S. tax liability through the use of cross-border payments to related persons.<sup>53</sup> Known as the Base Erosion and Anti-Abuse Tax (the “B.E.A.T. Regime”), the provision is viewed to be an attack against inbound base erosion through intercompany service fees, interest, rents, and royalties (“Base Erosion Payments”)<sup>54</sup> paid to 25% foreign related persons.<sup>55</sup> The B.E.A.T. Regime generally applies to corporate taxpayers that have average annual gross receipts of \$500 million or more during the testing period (the “gross receipts test”) and whose deductible payments to related parties equal or exceed 3% of their total allowed deductions (2% for certain banks and securities dealers).<sup>56</sup>

The B.E.A.T. Regime is not limited to U.S. corporations, but can also apply to foreign corporations with respect to income that is effectively connected with the conduct of a U.S. trade or business. However, for the purposes of determining whether a foreign corporation meets the gross receipts test, gross receipts are only included if they are taken into account when calculating the taxpayer’s U.S. effectively connected income.

If applicable, the B.E.A.T. Regime compares a tax of 10% (5% in 2018) imposed on the modified taxable income of a U.S. corporation with the 21% tax imposed on regular taxable income. If the tax on modified taxable income exceeds the regular tax, the excess is added to the regular tax for the year.

Modified taxable income under the B.E.A.T. Regime is broader than the concept of taxable income for regular tax purposes.<sup>57</sup> It is determined by adding the following items of deductible expense to the corporation’s taxable income:

- Deductions allocated to Base Erosion Payments in connection with payments made to 25% foreign related parties
- Depreciation and amortization deductions related to property purchased from 25% foreign related parties
- A specified portion of net operating losses from earlier years

For this purpose, a foreign entity is considered to be a 25% related foreign entity with regard to a corporation if it meets any of the following criteria:

- It is treated as owning shares in the U.S. corporation that represent at least 25% of the voting power or the value of all shares issued and outstanding.
- It is related to the corporation or to a 25% foreign owner of the corporation under constructive ownership rules similar to those discussed above that generally require more than 50% common ownership between two persons.

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<sup>53</sup> Code §59A.

<sup>54</sup> Code §59A(d).

<sup>55</sup> Code §59A(g).

<sup>56</sup> Code §59A(e)(1).

<sup>57</sup> Code §59A(c).

- It is treated as related to the taxpayer under the arm's length transfer pricing principles of U.S tax law. This means that one party controls the other or they are both under common control, no matter how exercised.

Certain payments that reduce U.S. tax are expressly removed from coverage under the B.E.A.T. Regime. These include the purchase price for inventory<sup>58</sup> and certain services that are generally of a kind that can be charged to a related party without a mark-up over costs without running afoul of the arm's length transfer pricing rules of U.S. tax law.<sup>59</sup> The I.R.S. is authorized to issue regulations that are necessary to prevent the avoidance of the B.E.A.T. Regime. Examples of abusive transactions include the use of unrelated persons, conduit transactions, or other intermediaries, or transactions or arrangements in ways that are designed, in whole or in part, to improperly recharacterize payments for the purpose of avoiding the B.E.A.T. Regime.

Limitations Placed on Business Interest Expense Deductions

Prior to the T.C.J.A., U.S. subsidiaries of foreign corporations were subject to an earnings stripping rule that applied when interest was paid to related parties outside the U.S. in circumstances where withholding tax was reduced or eliminated.<sup>60</sup> A cap was placed on the deduction for interest expense paid to a related party where the full 30% withholding tax was not collected, typically under the terms of an income tax treaty. The cap applied when the total net interest expense exceeded 50% of what is essentially E.B.I.T.D.A. and the debt-to-equity ratio exceeded 1.5 to 1.

The T.C.J.A. modifies the scope of these rules so that a ceiling is placed on the deduction for all business interest expenses. For taxable years beginning after 2017, the deduction for business interest is limited to the sum of business interest income and 30% of what is essentially E.B.I.T.D.A. for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely, subject to certain restrictions applicable to partnerships. Special rules exempt floor plan financing interest, which is typically used by automobile dealers,<sup>61</sup> as well as certain electing real property, farming, and utilities businesses, from the application of the 30% ceiling.<sup>62</sup>

Beginning in 2022, the ceiling is tightened by replacing the E.B.I.T.D.A. base with an E.B.I.T.-related base. Depreciation, amortization, and depletion are no longer added back to income when determining the base on which the 30% cap is computed.

Certain businesses are not covered by the ceiling. These include, *inter alia*, taxpayers with less than \$25 million in average annual gross receipts for the period of three taxable years ending with the prior taxable year and electing real property trades or businesses.<sup>63</sup>



<sup>58</sup> Preamble to REG-104259-18, Section III (Base Erosion Payments).

<sup>59</sup> Code §59A(d)(5).

<sup>60</sup> Code §163(j).

<sup>61</sup> Code §163(j)(1)(C).

<sup>62</sup> Code §163(j)(7)(A).

<sup>63</sup> Code §§163(j)(3) and 448(c).

### Other Revisions Affecting Cross-Border Groups

The T.C.J.A. made several other revisions to U.S. tax law affecting cross-border investors. The following list contains some of the more important changes:

- When valuing intangible property that is sold, transferred, or licensed to a related party, a taxpayer must consider realistic alternatives to the transaction as the methodology utilized by the taxpayer must apply the aggregate basis of valuation rather than an asset-by-asset method.<sup>64</sup>
- An exception to immediate gain recognition provided under prior law was eliminated,<sup>65</sup> resulting in the immediate recognition of gain in connection with a transfer of tangible assets used in an active trade or business to a related party outside the U.S.

### Biden Tax Proposals

In late Spring 2021, the Biden Administration announced its tax policies to pay for a spending program on domestic infrastructure and other items..

The highlights of the Biden Administration tax proposals addressing cross-border taxation were as follows:

- The corporate tax rate would be increased to 28%.
- A 15% minimum tax would be imposed on book income of corporations reporting more than \$2.0 billion of income for book purposes, as adjusted for certain items such as credits and book net operating losses.
- The anti-inversion rules would be strengthened by treating any acquisition of 50% or more ownership of a U.S. target or after the acquisition by a foreign corporation, the target continues to be managed or controlled by U.S. persons.
- The F.D.D.I. rules will be repealed and replaced by some form of research and development incentive targeted to U.S. activity.
- Both negative and positive incentives will be applied to grow jobs in the U.S. A 10% general business credit would be given for expenses incurred in connection with on-shoring of jobs. Expenses incurred in off-shoring of a U.S. trade or business would be nondeductible.

While many of the Biden Tax Proposals have not been enacted, they likely will be part of the next presidential election campaign.

### U.S. Foreign Tax Credit Regulations – In General

New I.R.S. regulations were adopted at the end of 2021 that are designed to limit the ability of U.S. taxpayers to offset U.S. tax by a credit for digital services taxes and other taxes that are imposed under foreign law, based on the assertion that the location of the customers creates a digital presence in the country.

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<sup>64</sup> Code §482.

<sup>65</sup> Code §367(a)(3) prior to enactment of the T.C.J.A.

Under long-standing principles followed by the I.R.S., a foreign income tax for which a foreign tax credit is claimed under U.S. tax law must be structured so that it is imposed on the net gain of the taxpayer. Three tests must be met in order for a tax to meet the net gain requirement:

- The realization test
- The gross receipts test
- The net income test

Under the realization test, the tax must be imposed at the time when income is realized.<sup>66</sup> Under the gross receipts test, the tax must be imposed on gross receipts or the equivalent.<sup>67</sup> Under the net income test, the tax must be imposed on net income after allowing for the recovery of expenses through immediate deductions against income or amortization of the total expenditure over time.<sup>68</sup>

In addition to the historic tests, the new regulations require close conformity to U.S. tax law and an attribution requirement that examines the jurisdictional basis for imposing tax. A nexus must exist between the transaction and the authority of the foreign government to impose tax. If an appropriate nexus does not exist, the tax is not a creditable income tax. As a result, some foreign taxes that were creditable under prior regulations may no longer be claimed as a credit. One of three nexus tests must be met in order for a foreign tax to have jurisdictional nexus to tax income. The first is an activities test. It broadly mirrors activities that would cause the income of a foreign enterprise to be taxed in the U.S. as effectively connected income.<sup>69</sup> The second test is a source of income test. Under that test, the income that is taxed by the foreign country must be based on source rules that are similar to those in the U.S. that are applied to foreign enterprises providing services in the U.S. or licensing intangible property for use in the U.S.<sup>70</sup> The third test is based on the location of property. For a tax on the disposition of real property to be creditable, the income or gain must be taxed by the foreign country based on concepts similar to those of F.I.R.P.T.A. For a tax on the disposition of personal property to be creditable, the income or gain must be taxed by the foreign country because it is business property of an office or fixed place of business of the enterprise in the country.<sup>71</sup>

The regulations take particular aim at taxes imposed under destination-based criteria, such as the location of a company's customers. This typically addresses digital services taxes which are imposed based on the location of the customer base.

### *U.S. Foreign Tax Credit Regulations – Pillar Two*

On December 11, 2023, the I.R.S. issued Notice 2023-55 (the "Notice"), announcing the intention to issue proposed regulations addressing the interaction between the Pillar Two GloBE Rules and specific U.S. tax provisions, including the foreign tax credit rules and dual consolidated loss rules. Pillar Two establishes a top-up tax

<sup>66</sup> Treas. Reg. §1.901-2(b)(2)(i).

<sup>67</sup> Treas. Reg. §1.901-2(b)(3).

<sup>68</sup> Treas. Reg. §1.901-2(b)(4)(i).

<sup>69</sup> Treas. Reg. §1.901-2(b)(5)(i)(A).

<sup>70</sup> Treas. Reg. §1.901-2(b)(5)(i)(B).

<sup>71</sup> Treas. Reg. §1.901-2(b)(5)(i)(C).

framework through the GloBE rules, which consists of the Income Inclusion Rule (“I.I.R.”) and the Undertaxed Payments Rule (“U.T.P.R.”). The issuance of this guidance is timely, as the I.I.R.’s of most countries took effect at the start of 2024, while the U.T.P.R.’s are scheduled to come into effect in 2025. The Notice does not cover the U.T.P.R.

The Notice describes rules addressing the treatment of certain taxes, including the I.I.R., U.T.P.R., and Q.D.M.T.T., under Code §§59(l), 78, 275, 704, 901, 903, 951A, 954, and 960. Code §901 generally allows a credit for foreign income taxes paid or accrued during the taxable year to any foreign country or U.S. territory, and in the case of a domestic corporation, the taxes deemed to have been paid under Code §960 in connection with Subpart F income and G.I.L.T.I. income generated by a C.F.C. Code §903 allows a credit for a foreign tax paid in-lieu-of a generally imposed income tax. Code §59(l) provides a corporate alternative minimum foreign tax credit. Code §275 addresses taxes that are not deductible when computing taxable income.

The rules are expected to have adverse implications for U.S. taxpayers, as both the I.I.R. and the U.T.P.R. are likely to be non-creditable for U.S. tax purposes.

A foreign income tax is a “final top-up tax” if the foreign tax law takes into account taxes imposed by other countries on the entity’s direct or indirect owners or on the entity itself for income earned in the foreign country. No credit is allowed under Code §§901 or 59(l) to a person for a final top-up tax if the foreign tax law takes into account any U.S. Federal income tax liability in computing the final top-up tax (without regard to whether the person has any amount of U.S. Federal income tax liability).

The final top-up tax is treated as if it were a creditable tax at the partnership and C.F.C. level, with the disallowance of the credit applying at the partner or U.S. shareholder level. This treatment is intended to facilitate appropriate results where a final top-up tax is creditable as to one partner or U.S. shareholder, but not as to another. Moreover, a final top-up tax is not taken into account in determining whether the high-tax exception under Subpart F or G.I.L.T.I. applies.

Specifically:

- A final top-up tax is treated as a creditable foreign tax expenditure under Treas. Reg. §1.704-1(b)(4)(viii)(b).
- A final top-up tax is treated as an eligible current year tax under Treas. Reg. §1.960-1(b)(5).
- In computing the effective rate of foreign income tax under Treas. Reg. §§1.954-1(d)(2) and 1.951A-2(c)(7)(vi), a final top-up tax is excluded from the amount of foreign income taxes described in Treas. Reg. §§1.954-1(d)(2)(i) and 1.951A-2(c)(7)(vi)(A). In addition, it increases the amount of the net item of income described in Treas. Reg. §1.951-1(d)(2)(ii) and the amount of the tentative tested income item described in Treas. Reg. §1.951A-2(c)(7)(vi)(B), as applicable.

If a taxpayer chooses to claim a foreign tax credit, the gross-up rule of Code §78 and the deduction disallowance rule of Code §275(a)(4) apply to any foreign income

*“The rules are expected to have adverse implications for U.S. taxpayers, as both the I.I.R. and the U.T.P.R. are likely to be non-creditable for U.S. tax purposes.”*





tax paid or accrued, including a final top-up tax. Code §78 requires a taxpayer to include a final top-up tax in gross income and Code §275(a)(4) denies a deduction for a final top-up tax.

The Notice provides that the I.R.S. and the Treasury Department intend to issue proposed regulations regarding how the separate levy rules of Treas. Reg. §1.901-2(d) apply with respect to an I.I.R., U.T.P.R., and Q.D.M.T.T. This treatment would reflect that the amount of tax imposed under an I.I.R., U.T.P.R., or Q.D.M.T.T. is computed separately from any other levy imposed by a foreign country and would ensure consistent treatment of an I.I.R., U.T.P.R., and Q.D.M.T.T. no matter how a foreign country constructs an I.I.R., U.T.P.R., or Q.D.M.T.T. Consequently, it does not matter whether the foreign country imposes these taxes independently or by adjusting the base of any other levy (such as through an addition to income or denial of deductions).

The Notice provides that the I.R.S. and the Treasury Department intend to issue proposed regulations establishing rules for determining the company deemed to be the payer of a Q.D.M.T.T. for purposes of Treas. Reg. §1.901-2(f) when a Q.D.M.T.T. is computed by reference to the income of two or more companies.

If a Q.D.M.T.T. is computed by reference to the income of two or more persons, foreign tax law is considered to impose legal liability for the Q.D.M.T.T. on each person in proportion to the person's Q.D.M.T.T. Allocation Key, as defined.

#### *GloBE and Dual Consolidated Loss Limitation Rules*

The Notice also addresses the interplay of the GloBE rules and the dual consolidated loss ("D.C.L.") rules of Code §1503(d). The rules aim to prevent "double dipping" of losses where the same economic loss offsets both U.S. taxable income and foreign taxable income.

Under the D.C.L. rules, a D.C.L. generally cannot offset the income of a domestic affiliate. An exception allows domestic use of a D.C.L. if the taxpayer makes a domestic use election, certifying no foreign use of the D.C.L. Foreign use occurs when any portion of the D.C.L. is used to offset income under a foreign country's tax laws. If foreign use happens during the certification period, the taxpayer must recapture the D.C.L. as ordinary income and pay interest on the deferred U.S. tax.

Under the GloBE rules, if an M.N.E. Group's E.T.R. for a jurisdiction is below the 15% minimum rate, it needs to calculate the Jurisdictional Top-up Tax owed for that jurisdiction. This tax is determined based on factors like Adjusted Covered Taxes and the Net GloBE Income of constituent entities within the jurisdiction.

The GloBE rules adopt a jurisdictional blending approach, where all income and loss of constituent entities in the same jurisdiction are generally combined. That aggregation raises concerns similar to those the D.C.L. rules were designed to address. For instance, if a loss resulting in a D.C.L. is combined with items that, according to U.S. tax principles, belong to a foreign corporation in that jurisdiction, the loss could be used to offset both U.S. tax (if a domestic use election is allowed) and the Jurisdictional Top-up Tax.

The I.R.S. is examining how the D.C.L. rules should apply to the GloBE rules. This includes looking at whether combining certain items through aggregation leads to a foreign use of a D.C.L. The I.R.S. is also assessing whether the GloBE rules should

classify an entity not otherwise subject to a foreign jurisdiction's income tax as a dual resident corporation or a hybrid entity under Treas. Reg. §§1.1503(d)-1(b)(2) or (3).

Additionally, the I.R.S. and the Treasury Department are considering whether these rules should prevent an entity from being treated as a transparent entity under Treas. Reg. §1.1503(d)-1(b)(16).

Finally, the I.R.S. is exploring similar issues in the context of other provisions, such as how the anti-hybrid rules under Code §§245A(e) and 267A interact with the GloBE rules.

## PATH FORWARD

Until this point, this article has looked in general at the challenges faced in cross-border tax planning in Europe and under the B.E.P.S. Project, and in a focused way, in the U.S. under the T.C.J.A. The balance of this article will examine the challenges now faced by tax planners within Europe.

We begin with a detailed look at how the B.E.P.S. Project has affected tax plans and how the European Commission is applying the concept of unlawful State Aid and the Anti-Tax Avoidance Directives to challenge sophisticated cross-border plans to achieve tax savings that were valid until just a few years ago. The article then proceeds to examine the tax treatment of companies in each of 17 European jurisdictions.

The goal is to determine whether a particular European 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. It must be staffed with competent persons having authority to make decisions and must avoid being a conduit to the U.S. parent.

For many U.S. planners advising corporate groups, this represents a major change of thinking, as the group's substance is frequently attributed to all group members – even those having no employees. This view is evident in the limitation on benefits article in U.S. income tax treaties where subsidiaries of publicly traded corporations qualify for treaty benefits and in determining whether a company is actively engaged in a trade or business, activities of a parent company or a 50% affiliate are attributed to the company.

However, in Europe, a company with no employees or activities is just a shell company. In today's world, tax benefits must be seen as non-abusive and business plans must be generated by operational personnel rather than tax advisers. A structure that is recommended based solely on an arithmetical rate of tax – net income multiplied by a low corporation tax rate – will likely face unpleasant surprises on both sides of the Atlantic.

# B.E.P.S. AND HOLDING COMPANIES

## Author

Paul Kraan  
Van Campen Liem  
Amsterdam, Netherlands

This chapter of the article was written by Paul Kraan of Van Campen Liem based on material originally prepared by Eric Fort, of Arendt & Medernach, Luxembourg.

## BACKGROUND

The B.E.P.S. Project is the name for today's most conceptually dense international tax reform proposal, and behind the acronym lies the hidden meaning of base erosion and profit shifting.

This project marks a sea change for some and the dawn of an improved system of international tax justice for others, especially academics and tax authorities. The B.E.P.S. Project originates 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<sup>1</sup> pointed out that globalization had damaged many states' core sovereignty, *i.e.*, their capacity to legitimately levy a compulsory tax on income produced by their residents. As observed later in 2013 by the 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, and it can also create gaps in cases where corporate income is not taxed at all, either by the country of source or by the country of residence, or where it is taxed only at nominal rates.<sup>2</sup>

Even if the development of bilateral tax treaties can solve the problem of double taxation, it is clear that gaps still remain at present. Cases of tax evasion by large multinational enterprises ("M.N.E.'s") and the international financial crisis made states eager to prevent practices that enable B.E.P.S., and citizens have also become more sensitive to issues of tax fairness.

Consequently, the G-20 mandated the O.E.C.D. to develop an action plan to address the B.E.P.S. issues and propose solutions. In particular, the action plan was intended to provide states with domestic and international instruments with which they could address these anticompetitive practices by M.N.E.'s and restore a sense of legitimacy in the source of taxation.

## B.E.P.S. ACTION PLAN

On July 19, 2013, the O.E.C.D. published the B.E.P.S. Action Plan,<sup>3</sup> addressing perceived flaws in international tax rules and transfer pricing rules, which were previously studied in a report released in February 2013.<sup>4</sup> The B.E.P.S. Action Plan proposed

<sup>1</sup> Communiqué of February 16, 2013.

<sup>2</sup> O.E.C.D. (2013), *Action Plan on Base Erosion and Profit Shifting*, O.E.C.D. Publishing.

<sup>3</sup> *Id.*

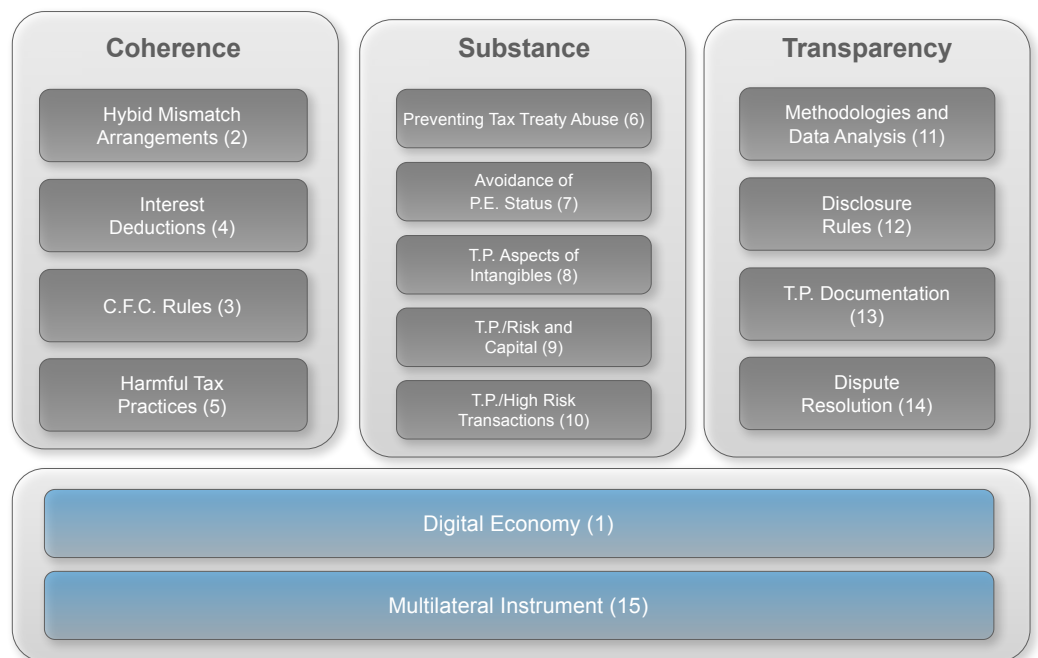
<sup>4</sup> O.E.C.D. (2013), *Addressing Base Erosion and Profit Shifting*, O.E.C.D. Publishing.

15 measures to combat various forms of B.E.P.S. In addition to the February report, the Action Plan identifies elements of concern in relation to double nontaxation or low taxation and proposes concrete actions with deadlines for compliance.

The actions are organized around three main pillars:

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

Aside from these pillars, the B.E.P.S. Action Plan also calls for the redressing of harmful practices in the digital economy and for the development of a multilateral instrument to implement the foregoing measures.



Overall, the Action Plan sets out how current cross-border taxation rules may create opportunities for B.E.P.S., thereby resulting in a reduction of tax.

As an initial response, the O.E.C.D. Committee on Fiscal Affairs adopted a preliminary set of seven reports and recommendations, which it published on September 16, 2014. This work reflected the view that different stakeholders must participate in the initiative. Developing countries and other nonmember economies of the O.E.C.D. and the G-20 were consulted at 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.

On October 5, 2015, the O.E.C.D. delivered a final package of 13 reports (the “Final Recommendations”), including the 2014 reports, to its members and the G-20.

Endorsed unanimously by the G-20 during their November 2015 meeting, the Final Recommendations contain the following set of guidelines:

- **Action Item 1:** Addressing the Tax Challenges of the Digital Economy
- **Action Item 2:** Neutralizing the Effects of Hybrid Mismatch Arrangements
- **Action Item 3:** Designing Effective Controlled Foreign Company Rules
- **Action Item 4:** Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
- **Action Item 5:** Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
- **Action Item 6:** Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
- **Action Item 7:** Preventing the Artificial Avoidance of Permanent Establishment Status
- **Action Items 8-10:** Aligning Transfer Pricing Outcomes with Value Creation
- **Action Item 11:** Measuring and Monitoring B.E.P.S.
- **Action Item 12:** Mandatory Disclosure Rules
- **Action Item 13:** Guidance on Transfer Pricing Documentation and Country-by-Country Reporting
- **Action Item 14:** Making Dispute Resolution Mechanisms More Effective
- **Action Item 15:** Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

As described in the explanatory statement released with the Final Recommendations, these measures range from new minimum standards (e.g., Action Item 5, Action Item 6, Action Item 13, and Action Item 14) to the revision of existing standards (e.g., Action Item 7 and Action Items 8-10), common approaches which will facilitate the convergence of national practices (e.g., Action Item 2, Action Item 3, Action Item 4, and Action Item 12), and guidance for the implementation of best practices (e.g., Action Item 1, Action Item 11, and Action Item 15).<sup>5</sup>

Compliance with the minimum standards is ensured via the peer reviews by O.E.C.D. members and the G-20 in accordance with a more in-depth framework.

Despite constituting soft law, the Final Recommendations are being or have been implemented by the G-20, European countries, and others.

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<sup>5</sup> O.E.C.D. (2015), *Explanatory Statement*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D.

## REFLECTING A SEA CHANGE IN ACCEPTABLE TAX PLANNING

The B.E.P.S. Project demonstrates 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, rather than abusive practices by certain operators. Cynics might say that the change is one in which smaller economies that thrived on arrangements to reduce tax in other countries will be required to reshape their economies to focus on more productive endeavors.

In calling for an internationally 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. created a mandate through Action Item 15 that called for an international conference to develop a multilateral instrument to amend the network of existing bilateral tax treaties in order to implement the B.E.P.S. Project's treaty measures all at once (the "M.L.I."). On November 24 and 25, 2016, negotiations regarding the M.L.I. among over 100 jurisdictions were concluded and a signing ceremony was held on June 7, 2017, in Paris. The M.L.I. now covers around 1,900 bilateral tax treaties worldwide.

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

## 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. Action Plan. The ground rules under which plans were proposed and implemented in the past may not provide useful guidance in the future.

The B.E.P.S. Project affects the fiscal engineering surrounding the different levels of involvement of a typical holding structure, and especially around holding companies, financing companies, and I.P. holding companies.

The B.E.P.S. Actions described below present the uses of B.E.P.S. by holding companies in every form and indicate how the O.E.C.D. intends to tackle such practices.



## B.E.P.S. ACTION 1: ADDRESSING THE TAX CHALLENGES OF THE DIGITAL ECONOMY

The 2015 B.E.P.S. Action 1 Report<sup>6</sup> focuses on the tax challenges of the digitalization of the economy and is driven by the idea that in the digital age, the allocation of taxing rights can no longer be exclusively circumscribed by reference to physical presence.

On May 29, 2019, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. approved the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*<sup>7</sup> (the “Programme”), which is intended to be a roadmap for resolving the tax challenges arising from the digitalization of the economy providing for a process in order to reach a new global agreement for taxing multinational enterprises. The *Programme* foresees two main pillars:

- Pillar one<sup>8</sup> for the allocation of taxation rights (*revised nexus and profit allocation rules*)
- Pillar two<sup>9</sup> concerning a minimum level of tax (*global anti-base erosion proposal*)

On October 14, 2020, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. published the two reports on the Pillar One Blueprints<sup>10</sup> and the Pillar Two Blueprints<sup>11</sup> (the “Blueprints”) and sought public comments.

On October 1, 2021, 137 jurisdictions released a joint statement<sup>12</sup> establishing a framework for Pillar One and Pillar Two. Not all Inclusive Framework members have joined as of June 23, 2023.

On December 1, 2021, the O.E.C.D. released model rules under Pillar Two<sup>13</sup> for establishing a global minimum tax. On March 14, 2022, the O.E.C.D. released detailed technical guidance on the Pillar Two model rules, including commentary<sup>14</sup> on the

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<sup>6</sup> O.E.C.D. (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, O.E.C.D./G20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

<sup>7</sup> O.E.C.D. (2019), *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, O.E.C.D./G-20 Inclusive Framework on B.E.P.S., O.E.C.D., Paris.

<sup>8</sup> *Programme*, p. 9 *et seq.*

<sup>9</sup> *Programme*, p. 25 *et seq.*

<sup>10</sup> O.E.C.D. (2020), *Tax Challenges Arising from Digitalization – Report on Pillar One Blueprints*, O.E.C.D./G-20 Inclusive Framework on B.E.P.S., O.E.C.D., Paris (the “Pillar One Blueprint”).

<sup>11</sup> O.E.C.D. (2020), *Tax Challenges Arising from Digitalization – Report on Pillar Two Blueprints*, O.E.C.D./G-20 Inclusive Framework on B.E.P.S., O.E.C.D., Paris (the “Pillar Two Blueprint”).

<sup>12</sup> O.E.C.D. (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy*.

<sup>13</sup> O.E.C.D. (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)*.

<sup>14</sup> O.E.C.D. (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*.

global anti-base erosion model rules with illustrative examples,<sup>15</sup> and sought public comments.

Since 2022, the O.E.C.D. sought and received public comments on various aspects of Pillar Two. Between 2023 and 2024, the O.E.C.D. issued further administrative guidance on Pillar Two.<sup>16</sup>

Since 2022, the O.E.C.D. sought and received public comments on several aspects of the draft rules for (i) Amount A under Pillar One (including nexus and revenue sourcing, tax base determinations, scope, extractives exclusion, regulated financial services exclusion, tax administration and tax certainty, and multilateral convention provisions on digital services taxes) as well as (ii) Amount B of Pillar One. In 2024, the O.E.C.D. published a final report on Amount B of Pillar One.<sup>17</sup>

## **Pillar One**

The different approaches discussed under pillar one have the following aspects in common:<sup>18</sup>

- Reallocation of taxing rights in favor of the user/market jurisdiction
- A new nexus rule that would not depend on physical presence in the user/market jurisdiction
- Going beyond the arm's length principle and departing from the separate entity principle
- Striving towards simplicity, stabilization of the tax system, and increased tax certainty in implementation

On October 9, 2019, the O.E.C.D. published a public consultation document<sup>19</sup> describing the “Unified Approach” under Pillar One and on October 14, 2020, the O.E.C.D. published the Pillar One Blueprint, according to which the key features for a common solution should be as follows:

- **Scope:** In addition to automated digital services, consumer-facing businesses should be within the scope of the provision. However, sectors not in scope include notably extractive industries; certain financial services; construction; sale and leasing of residential properties; and international air and shipping businesses. Additionally, the Pillar One Blueprint provides that below two revenue-based thresholds (*i.e.*, a “global revenue” threshold based on the

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<sup>15</sup> O.E.C.D. (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) Examples*.

<sup>16</sup> O.E.C.D. (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*.

<sup>17</sup> O.E.C.D. (2024), *Pillar One - Amount B: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*.

<sup>18</sup> Public consultation document, Secretariat Proposal for a “Unified Approach” under Pillar One, 9 October 2019 – 12 November 2019, p. 4.

<sup>19</sup> Public consultation document, Secretariat Proposal for a “Unified Approach” under Pillar One, 9 October 2019 – 12 November 2019.



annual consolidated group revenue<sup>20</sup> and a “*de minimis* foreign in-scope revenue” threshold), the rules do not apply.

- **New Nexus:** Nexus based on sales in excess of certain thresholds. In relation to consumer-facing businesses, a “plus factor” to indicate a significant and sustained engagement with the market (e.g., a subsidiary or a “fixed place of business”) should be considered in order to achieve a Nexus. Nexus is not dependent on physical presence. The new nexus should be designed as a new self-standing provision.
- **Tax Base Determination:** The tax base is determined on the basis of the profits of a group (rather than on a separate entity basis).
- **New Profit Allocation Rule** going beyond the Arm’s Length Principle: Irrespective of an in-country marketing or distribution presence in the form of a permanent establishment or separate subsidiary or sales made via unrelated distributors. A three-step formulaic approach should identify the quantum of Amount A to be allocated to a business’s marketing jurisdictions by applying (i) a “profitability threshold,” (ii) a “reallocation percentage,” and (iii) an “allocation key.”
- **Elimination of Double Taxation:** A mechanism that reconciles the new taxing right and the existing profit allocation rules is necessary to prevent double taxation by identifying the jurisdiction that must relieve double taxation.
- **A Three-Tier Profit Allocation Mechanism:**
  - **Amount A:** The adoption of a new taxing right for the market jurisdiction, giving it a share of a *deemed residual profit* by using a formulaic approach.

The deemed residual profit would be the profit that remains after allocating what would be regarded as a *deemed routine profit* on activities to the countries where the activities are performed.<sup>21</sup>
  - **Amount B:** A fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction.

Activities in market jurisdictions, and in particular distribution functions, remain taxable according to existing rules regarding transfer pricing under the arm’s length principle and permanent establishment allocations of profit. However fixed remuneration should be used reflecting an assumed baseline activity. A precise definition of activities qualifying for the fixed return is yet to be determined.
  - **Amount C:** Given the double taxation risks inherent in Amount A, it is intended to determine and implement a legally binding and effective dispute prevention and resolution method which would operate on a multilateral basis.

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<sup>20</sup> For example, the €750 million revenue threshold used for country-by-country reporting requirements.

<sup>21</sup> Public consultation document, Secretariat Proposal for a “Unified Approach” under Pillar One, 9 October 2019 – 12 November 2019.

The framework for Pillar One released in 2021 includes the following main points:

- Companies included in the scope of Pillar One are multinational enterprises (“M.N.E.’s”) with global turnover above €20 billion and profitability above 10%. The turnover threshold will be reduced to €10 billion, contingent upon the successful implementation of tax certainty on Amount A. The relevant review would begin seven years after the agreement comes into force, and the review would have to be completed in no more than one year. Extractives and regulated financial services are excluded.
- A special purpose nexus rule will allocate Amount A to a market jurisdiction when the affected M.N.E. derives at least €1 million in revenue from that jurisdiction. For smaller jurisdictions with a G.D.P. under €40 billion, the nexus will be set at €250,000. The special purpose nexus rule will apply to determine whether a jurisdiction qualifies for the Amount A allocation.
- For affected M.N.E.’s, 25% of their residual profit, defined as profit in excess of 10% of revenue, will be allocated to market jurisdictions with nexus using a revenue-based allocation key. The profit or loss of the affected M.N.E. will be determined by its financial accounting income, with adjustments. Losses will be carried forward. Where the residual profits of an affected M.N.E. are already taxed in a market jurisdiction, a marketing and distribution profits safe harbor rule will cap the residual profits allocated to the market jurisdiction through Amount A.
- Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method. Tax liability will be drawn from those entities that earn residual profit. Affected M.N.E.’s will benefit from dispute prevention and resolution mechanisms.
- The work on Amount B and the application of the arm’s length principle to in-country baseline marketing and distribution activities.
- A Multilateral Convention (“M.L.C.”) will require all parties to remove all digital services taxes and commit to not introducing such measures in the future.

To implement Pillar One, the O.E.C.D. will develop the M.L.C. and an explanatory statement, model rules for domestic legislation, and the related commentary through which Amount A will be implemented.

In 2022 and 2023, the O.E.C.D. sought and received public comments on the following aspects of Pillar One:

- **Draft rules for nexus and revenue sourcing under Amount A under Pillar One.**<sup>22</sup> These rules will be outlined in Title 4 of the model rules and incorporated into the M.L.C. and its explanatory statement. To determine whether a group satisfies the nexus test for Amount A in a jurisdiction, it will have to apply the revenue sourcing rules by identifying the market jurisdiction for a given type of revenue: finished goods, components, services, intangible property, real property, government grants, and non-customer revenues.



<sup>22</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing*.

- **Draft rules for tax base determinations under Amount A under Pillar One.**<sup>23</sup> These rules will be outlined in Title 5 and in Title 9 (definitions) of the model rules and will be incorporated into the M.L.C. and explanatory statement. The model rules on tax base are designed to calculate the profit (or loss) of a group for the purposes of determining Amount A, based on the consolidated group financial accounts. The starting point will be the consolidated profit and loss statement, but certain book-to-tax adjustments, adjustments with respect to profit (or loss) restatements in relation to prior periods, and loss carry forward rules will apply.
- **Draft rules for scope under Amount A under Pillar One.**<sup>24</sup> These rules will be outlined in Title 2 and in Title 9 (definitions) of the model rules and will be incorporated into the M.L.C. and explanatory statement. The model rules on scope determine when a group will be included in the scope of Amount A and subject to the detailed provisions contained within the model rules.
- **Extractives exclusion under Amount A under Pillar One.**<sup>25</sup> These rules will exclude the profits from extractive activities from the scope of Amount A. Extractive activities are defined by reference to two cumulative elements: a “product test” and an “activities test.”
- **Regulated financial services exclusion under Amount A under Pillar One.**<sup>26</sup> These rules will exclude the revenues and profits of the following categories of regulated financial institutions from the scope of Amount A:
  - Depository institutions
  - Mortgage institutions
  - Investment institutions
  - Insurance institutions
  - Asset managers
  - Mixed financial institutions
  - Regulated financial institution service entities

The definition for each type of regulated financial institution generally contains three cumulative elements: a licensing requirement, a regulatory capital requirement, and an activities requirement.

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<sup>23</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Model Rules for Tax Base Determinations*.

<sup>24</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Model Rules for Domestic Legislation on Scope*.

<sup>25</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Extractives Exclusion*.

<sup>26</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Regulated Financial Services Exclusion*.

- **Tax certainty aspects of Amount A under Pillar One, including a tax certainty framework for Amount A<sup>27</sup> and a tax certainty process for issues related to Amount A.<sup>28</sup>** The framework guarantees certainty for affected groups over all aspects of the new rules, including the elimination of double taxation. The process for resolving issues set out a mandatory and binding mechanism that will be used to resolve transfer pricing and permanent establishment profit attribution disputes that competent authorities are unable to resolve through the mutual agreement procedure (“M.A.P.”) within two years of the presentation of the case to the competent authorities. The related rules will be incorporated into the model rules, the M.L.C., or other agreements and tools as needed.
- **Progress report on Amount A.<sup>29</sup>** The report includes a consolidated version of the operative provisions on Amount A (presented in the form of domestic model rules) reflecting the technical work completed so far.
- **Progress report on the tax administration and tax certainty aspects of Pillar One.<sup>30</sup>** The report contains draft rules on the administration of the new taxation rights as well as provisions on tax certainty. In particular, Part I of the report covers the administration process for Amount A, from the filing of the relevant information to payment of tax and access to timely relief from double taxation.
- **Draft M.L.C. provisions on digital services taxes and other relevant measures.<sup>31</sup>** This consultation document contains draft M.L.C. provisions implementing the rules for digital services taxes and other relevant measures, including (i) an obligation to withdraw the measures listed in an annex to the M.L.C. and stop applying them to any company, (ii) a definition of the measures the parties to the M.L.C. will commit not to enact in the future, and (iii) a mechanism that will eliminate Amount A allocations if this commitment is breached.
- **Amount B under Pillar One.<sup>32</sup>** This consultation document outlines the main design elements of Amount B: the scope, the pricing methodology, and the current status of discussions concerning an appropriate implementation framework. The scope of Amount B defines the controlled transactions and sets out qualitative and quantitative criteria to help that determination. If the criteria are met and the taxpayer is therefore within the scope of Amount B, the Amount B pricing methodology would be applied to establish the arm’s

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<sup>27</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – A Tax Certainty Framework for Amount A*.

<sup>28</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Tax certainty for issues related to Amount A*.

<sup>29</sup> O.E.C.D. (2022), *Public consultation document, Progress Report on Amount A of Pillar One*.

<sup>30</sup> O.E.C.D. (2022), *Public consultation document, Progress Report on the Administration and Tax Certainty Aspects of Pillar One*.

<sup>31</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Multilateral Convention Provisions on Digital Services Taxes and other Relevant Similar Measures*.

<sup>32</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount B*.

length price for the transaction, subject to potential exemptions which are currently under consideration.

- **Amount B under Pillar One.**<sup>33</sup> This consultation document outlines the Amount B under Pillar One scoping framework. The scope of Amount B focuses on a set of baseline wholesale distributors that can be reliably priced under a one-sided transfer pricing method by applying the pricing framework.<sup>34</sup> The Amount B scoping framework also permits the undertaking of *de minimis* retail sales, while excluding the distribution services and commodities from the scope.

In 2023, the O.E.C.D. released the text of a new M.L.C. together with an Explanatory Statement and the document “The Understanding on the Application of Certainty for Amount A of Pillar One.” The Explanatory Statement accompanies the M.L.C. and provides clarification on how each provision is intended to apply. “The Understanding on the Application of Certainty” contains further details on how aspects of the Amount A tax certainty framework will operate in practice.

On February 19, 2024, the O.E.C.D. published a final report on Amount B under Pillar One.<sup>35</sup> The final report on Amount B under Pillar One includes the following main points:

- **Considerations relating to the application of the simplified and streamlined approach.** This point explains how jurisdictions will implement Amount B under Pillar One.
- **Transactions in scope.** This point defines transactions in scope of Amount B.
- **Application of the most appropriate method principle to in-scope transactions.** This point provides that qualifying transactions will be priced using the Transactional Net Margin Method (“T.N.M.M.”) under the simplified and streamlined approach, unless an internal comparable uncontrolled price (“C.U.P.”) can be identified.
- **Determining the return under the simplified and streamlined approach.** This point sets out how to price the returns due to in-scope distributors based on a standardized pricing matrix. It also includes a return on operating expenses crosscheck and a mechanism to adjust the returns for jurisdictions with low sovereign credit ratings and limited benchmarking data availability in the commercial database used by the O.E.C.D.
- **Documentation.** This point sets out the documentation requirements for businesses applying Amount B.
- **Transitional issues.** This point addresses scenarios in which business restructuring will cause a distributor to fall in or out of scope of Amount B.

“In 2023, the O.E.C.D. released the text of a new M.L.C. together with an Explanatory Statement and the document ‘The Understanding on the Application of Certainty for Amount A of Pillar One.’”

<sup>33</sup> O.E.C.D. (2023), Public consultation document, Pillar One – Amount B.

<sup>34</sup> In-scope distributors, for instance, should not own unique and valuable intangibles, nor should they assume certain economically significant risks.

<sup>35</sup> O.E.C.D. (2024), Pillar One - Amount B: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project.

- **Tax certainty and elimination of double taxation.** This point governs the relationship between counterparty jurisdictions, when one jurisdiction seeks to apply Amount B, to ensure tax certainty and the elimination of double taxation.

Further administrative guidance on Amount B under Pillar One was released by the O.E.C.D. on June 17, 2024.

## **Pillar Two**

On November 8, 2019 the O.E.C.D. published a public consultation document<sup>36</sup> on Pillar Two for the development of a coordinated set of rules to address ongoing risks from structures that allow multinational enterprises to shift profit to jurisdictions where they are subject to no or very low taxation. On October 14, 2020, the O.E.C.D. published the Pillar Two Blueprint. Pillar Two foresees a global minimum tax regime with an agreed effective minimum tax rate for internationally operating businesses within its scope. Changes to domestic law and tax treaties will be required.

The effective minimum tax rate would both (i) identify “low tax jurisdictions” (*i.e.*, where a multinational enterprise’s jurisdictional effective tax rate would be below the agreed minimum rate) and (ii) determine how much income must be brought back into the tax net to raise the aggregate tax on income in that jurisdiction to the effective tax rate.

The proposal contains four rules for the case where income is not subject to tax at a minimum rate.

### **Income Inclusion Rule**

Income of a foreign branch or a controlled entity that is not subject to tax at a minimum rate should be taxed.

### **Undertaxed Payments Rule**

A payment to a related party, which is not subject to tax at a minimum rate at the recipient’s level, should not be tax deductible or should be subject to a withholding tax taxed at source.

### **Switch-over Rule in Tax Treaties**

Where the profits attributable to a permanent establishment (“P.E.”) or derived from immovable property which is not part of a P.E. are not subject to tax at a minimum rate, the residence jurisdiction should be permitted to switch from an exemption to a credit method.

### **Subject to Tax Rule**

Where the payment is not subject to tax at a minimum rate, taxation at source should apply and the eligibility for treaty benefits may be restricted.

The relevant minimum tax rate is still to be determined.

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<sup>36</sup> Public consultation document, Global Anti-Base Erosion Proposal (“GloBE”) - Pillar Two, November 8, 2019 –December 2, 2019, page 9, paragraph 30.

***“With respect to Pillar Two, they committed to a global minimum tax rate of at least 15%, determined on a country-by-country basis.”***

The public was invited to submit written comments on the Blueprints by December 14, 2020, and a public consultation meeting was held virtually on January 14 and 15, 2021. The public consultation meeting focused on the key questions identified in the consultation document and raised in the written submissions that were received.

On June 5, 2021, the Finance Ministers and Central Bank Governors of the G7 countries released a communiqué supporting the efforts of G20/OECD Inclusive Framework on B.E.P.S. that address (i) tax challenges arising from globalization and digitalization of the economy and (ii) proposals to adopt a global minimum tax. They agreed on the importance of progressing both Pillars and reaching an agreement at the July meeting of G20 Finance Ministers and Central Bank Governors. With respect to Pillar Two, they committed to a global minimum tax rate of at least 15%, determined on a country-by-country basis.

### 2021 Framework

The framework released in 2021 for Pillar Two consists of the following:

- Two interlocking domestic rules known as the global anti-base erosion rules (“GloBE”) rules: (i) an income inclusion rule (“I.I.R.”) which imposes a top-up tax on a parent entity in respect to the low-taxed income of a constituent entity and (ii) an undertaxed payment rule (“U.T.P.R.”) which denies deductions or requires an equivalent adjustment to the extent the low-taxed income of a constituent entity is not subject to tax under an I.I.R.
- A treaty-based rule known as the subject to tax rule (“S.T.T.R.”) that allows source jurisdictions to impose limited source taxation on certain related party payments subject to tax below a minimum rate. The S.T.T.R. will be creditable as a covered tax under the GloBE rules.

### Model Rules for Global Minimum Tax

On December 1, 2021, the O.E.C.D. released model rules for Pillar Two<sup>37</sup> that would establish a global minimum tax.

Taxpayers that either have no foreign presence or that have less than €750 million in consolidated revenues are not inside the scope of the model rules. In addition, the Pillar Two model rules do not apply to government entities, international organizations, and non-profit organizations, nor do they apply to entities that meet the definition of a pension, investment, or real estate fund. These entities are excluded, but the M.N.E. group they control remains subject to the rules.

Taxpayers inside the scope of the rules must calculate their effective tax rate for each jurisdiction where they operate and pay top-up tax for the difference between their effective tax rate (“E.T.R.”) per jurisdiction and the 15% minimum rate. Any resulting top-up tax is generally charged in the jurisdiction of the ultimate parent of the M.N.E. A *de minimis* exclusion applies where there is a relatively small amount of revenue and income in a jurisdiction.

<sup>37</sup> O.E.C.D. (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*.

The rules are drafted as model rules that provide a template that jurisdictions can translate into domestic law:

- Chapter 1 addresses questions of scope.
- Chapters 2-5 contain the key operative rules. An M.N.E. can apply the rules in the following steps:
  - Calculate the effective tax rate in each jurisdiction where the M.N.E. operates. This requires a calculation of the income and of the tax on that income. The income (or loss) is calculated based on financial accounts, with certain adjustments to reflect common permanent differences, remove certain dividends and equity gains, or expenses disallowed for tax purposes. There is an exclusion for international shipping income. The tax attributable to that income includes income taxes. The rules also address temporary differences which arise when income or loss is recognized in a different year for financial accounting and tax.
  - Calculate the top-up tax where there is low taxed income in a jurisdiction. The rate of tax owed is the difference between the 15% minimum rate and the E.T.R. in the jurisdiction. That top-up tax percentage is then applied to the GloBE income in the jurisdiction, after deducting a substance-based income exclusion (calculated as a percentage mark-up on tangible assets and payroll costs). If a jurisdiction has a domestic minimum tax that is consistent with the Pillar Two model rules, such domestic tax is credited against any Pillar Two minimum tax liability.
  - Determine the liability for the top-up tax, *i.e.*, which entity within the M.N.E. will be liable for the top-up tax on the low-taxed income arising in a jurisdiction. Under the I.I.R., the minimum tax is paid at the level of the parent entity, in proportion to its ownership interests in those entities that have low-taxed income. Generally, the I.I.R. is applied at the top, at the level of the ultimate parent entity, and works its way down the ownership chain. The U.T.P.R. is the backstop rule which requires an adjustment (such as a denial of a deduction) that increases the tax at the level of the subsidiary and which is sufficient to result in the group entities paying their share of the top-up tax remaining after the I.I.R.
- Chapter 6 deals with mergers and acquisitions.
- Chapter 7 provides special rules that apply to certain tax neutrality and existing distribution tax regimes.
- Chapter 8 provides an internationally coordinated approach to administering the rules. This includes a standardized information return, mechanisms to avoid duplicative reporting, and the scope to release coordinated guidance on the application of the rules in practice. Chapter 8 also provides for the possibility of safe harbors.
- Chapter 9 provides for rules on transition.
- Chapter 10 contains definitions.



The preamble to the Pillar Two model rules indicates that consideration will be given to the conditions under which the U.S. Global Intangible Low-Taxed Income (“G.I.L.T.I.”) regime will co-exist with the GloBE rules to ensure a level playing field.

On March 14, 2022, the O.E.C.D. released detailed technical guidance on the Pillar Two model rules, including commentary on the global anti-base erosion model rules<sup>38</sup> and illustrative examples<sup>39</sup> and sought public comments. The commentary provides guidance on the interpretation and application of the GloBE rules to ensure a consistent and common interpretation. It also includes examples which illustrate the application of the rules for certain fact patterns.

On December 20, 2022, the O.E.C.D. released guidance on safe harbors and penalty relief<sup>40</sup> which includes the terms of a transitional country-by-country reporting safe harbor. It essentially removes the obligation for an M.N.E. to calculate the GloBE effective tax rate for its operations in lower-risk jurisdictions in its initial years, thereby providing some relief from GloBE compliance obligations as M.N.E.’s implement the rules. The document includes a framework for the development of permanent safe harbors as simplified income and tax calculations. It also provides a common understanding for a transitional penalty relief regime which requires careful consideration when applying penalties or sanctions where an M.N.E. has taken reasonable measures to ensure the correct application of the GloBE rules.

On February 2, 2023, the O.E.C.D. released administrative guidance for the Pillar Two GloBE rules.<sup>41</sup> The administrative guidance will ensure coordinated outcomes and greater certainty for businesses as they move to apply the global minimum corporate tax rules from the beginning of 2024. The administrative guidance will be incorporated into a revised version of the commentary that will be released later in 2023, replacing the original version of the commentary issued in March 2022. The Inclusive Framework will continue to release further administrative guidance on an ongoing basis to ensure that the GloBE rules continue to be implemented and applied in a coordinated manner.

On February 3, 2023, the O.E.C.D. sought and received public comments on the GloBE information return (“G.I.R.”),<sup>42</sup> particularly on the data points that an M.N.E. group may need to collect in order to calculate the M.N.E. group’s GloBE tax liability. The G.I.R. is intended to provide a framework for collecting information from M.N.E. groups that are within the scope of the GloBE rules on an annual basis, so that a tax administration is provided with the necessary information on the tax calculations made by the M.N.E. group so it can evaluate the correctness of a constituent entity’s tax liability under the GloBE rules.



<sup>38</sup> O.E.C.D. (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*.

<sup>39</sup> O.E.C.D. (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) Examples*.

<sup>40</sup> O.E.C.D. (2022), *Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)*.

<sup>41</sup> O.E.C.D. (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*.

<sup>42</sup> O.E.C.D. (2022), *Public consultation document, Pillar Two – GloBE Information Return*.

***“The G.I.R. will be subject to coordinated filing and exchange mechanisms that allow M.N.E.’s to report their GloBE calculations on a single return, where the more detailed information is made available to implementing jurisdictions where a top-up tax liability may arise.”***

On February 3, 2023, the O.E.C.D. sought and received public comments on various mechanisms for achieving tax certainty under the GloBE rules.<sup>43</sup> These mechanisms would apply in advance of any action being taken by jurisdictions (*i.e.*, dispute prevention mechanisms such as reliance on commentary and administrative guidance developed by the Inclusive Framework and the conclusion of bilateral or multilateral advance pricing arrangements) as well as after action has been taken (*i.e.*, dispute resolution mechanisms through an existing legal instrument such as tax treaties or the Convention on Mutual Administrative Assistance in Tax Matters or through new mechanisms such as a new multilateral convention or under domestic law).

On July 17, 2023, the O.E.C.D. released a report on the G.I.R.<sup>44</sup> The G.I.R. incorporates transitional simplified reporting requirements that allow M.N.E.’s to report their GloBE calculations at a jurisdictional level. The G.I.R. will be subject to coordinated filing and exchange mechanisms that allow M.N.E.’s to report their GloBE calculations on a single return, where the more detailed information is made available to implementing jurisdictions where a top-up tax liability may arise.

Additionally, on July 17, 2023, the O.E.C.D. released administrative guidance for the Pillar Two GloBE rules.<sup>45</sup> It includes guidance on currency conversion rules when performing GloBE calculations, on tax credits, and on the application of the Substance-based Income Exclusion (“S.B.I.E.”). It also includes further guidance on the design of Qualified Domestic Minimum Top-up Taxes (“Q.D.M.T.T.”) as well as two new safe harbors: (i) a permanent safe harbor for jurisdictions that introduce a Q.D.M.T.T., which will make compliance and administration easier for M.N.E.’s and tax administrations; and (ii) a transitional safe harbor, which provides the U.P.E. jurisdiction with relief from the application of the U.T.P.R. for fiscal years commencing on or before the end of 2025.

On December 18, 2023 and June 17, 2024, the O.E.C.D. released administrative guidance for the Pillar Two GloBE rules<sup>46</sup> which supplements the Commentary to the Global Anti-Base Erosion Model Rules. Its purpose is to clarify their application, including guidance on the application of the Transitional Country-by-Country Reporting Safe Harbor, a mechanism for allocating taxes arising under a Blended Controlled Foreign Corporation (“C.F.C.”) Tax Regime when some of the jurisdictions in which the M.N.E. operates are eligible for the safe harbor, as well as guidance on the application of the recapture rule applicable to deferred tax liabilities (“D.T.L.”), cross-border allocation of current and deferred taxes, allocation of profits and taxes in certain structures involving flow-through entities, and the treatment of securitization vehicles.

<sup>43</sup> O.E.C.D. (2022), *Public consultation document, Pillar Two – Tax Certainty for the GloBE rules*.

<sup>44</sup> O.E.C.D. (2023), *Tax Challenges Arising from the Digitalisation of the Economy – GloBE Information Return (Pillar Two)*.

<sup>45</sup> O.E.C.D. (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*.

<sup>46</sup> O.E.C.D. (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)*.

On April 25, 2024, the O.E.C.D. released its consolidated commentary for the Pillar Two GloBE rules.<sup>47</sup> The consolidated commentary incorporates guidance published by the O.E.C.D. before the end of December 2023.

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

### **Focus**

Action Item 2 of the B.E.P.S. Action Plan focuses on hybrid mismatch arrangements frequently used by holding companies. The goal 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.

Three types of hybrid arrangements fall within the scope of Action Item 2:

- Hybrid financial instruments, *e.g.*, instruments that are treated as equity in one jurisdiction and as debt in another
- Hybrid transfers, *e.g.*, transfers that are treated as to their form in one jurisdiction and as to their economic substance in another
- Hybrid entities, *e.g.*, entities that are treated as taxable in one jurisdiction and as transparent in another

In the Final Recommendations, the O.E.C.D. confirmed the guidelines set out in its intermediary report presented in 2014.

As a result, two basic mismatched tax outcomes were distinguished:

- An outcome involving a deduction in one country with no inclusion of income in another country (“D./N.I.”)
- 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.

Further, it should be noted that the O.E.C.D. issued additions to its Final Recommendations. The additions address hybrid mismatches<sup>48</sup> resulting from differences in the way payments between a permanent establishment and its head office are characterized under local tax law. The aim of these specific recommendations is to

<sup>47</sup> O.E.C.D. (2024), *Tax Challenges Arising from the Digitalisation of the Economy – Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project*.

<sup>48</sup> O.E.C.D. (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

align the treatment of such structures with the treatment of classic hybrid mismatch arrangements.

### **Illustrative Fact Patterns**

For the purpose of this chapter and due to the broad scope of Action Item 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 or holder treats the payment as a tax-exempt dividend.

Another example of hybrid mismatch can be found in arrangements with payments to reverse hybrid entities. Such entities are treated as tax transparent in one jurisdiction and as opaque in another. By way of illustration, a company that is resident in Country A owns all the issued and outstanding shares in a subsidiary resident in Country B. The subsidiary 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.<sup>49</sup>

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. By way of illustration, Company A, a resident in Country A, owns all the issued and outstanding 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 the 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 payer of the interest as the primary rule, and if the primary rule is not adopted in the relevant country, the imposition of tax in the country of the recipient as a secondary rule. In practice, when two jurisdictions are involved in a hybrid mismatch arrangement, the primary rule should determine which of the two

<sup>49</sup> O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

jurisdictions ensures that tax is collected. In the event the jurisdiction of the payer has not 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 controlled foreign corporation (“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.

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 unduly to obtain the benefits of treaties. The latest edition of the O.E.C.D. Model Tax Convention, of November 2017, reflects the additional hybrid mismatches recommendations under Action Item 2.

## B.E.P.S. ACTION 3: DRAFTING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES<sup>50</sup>

### Focus

The objective of the C.F.C. rules is to avoid or neutralize cases where groups or individuals create affiliates that may be established wholly or partly for tax reasons in other jurisdictions in order to be repositories of diverted income. In other words, the aim of the C.F.C. rules are to avoid the shift of income by ensuring that profits remain in the taxable base of the controlling entity in relation to the C.F.C.

In this context, and on a consolidated basis, the effect of C.F.C. rules are not to increase the taxable base of a group of entities located in several jurisdictions but to ensure its substantial allocation between each group member by reallocating all or part of the taxable base between the parent and subsidiary entities.

C.F.C. rules have been implemented in domestic jurisdictions since 1962 and continue to be adopted by an increasing number of countries since then. However, not all countries have adopted such measures in national legislation, and a gap in compliance exists.

In the general framework of the B.E.P.S. Project, Action Item 3 focuses on recommendations that aim to develop and design new C.F.C. rules that are efficient in a B.E.P.S. context. Such recommendations are focused on six topics which can be divided into three parts:

- Definitions of C.F.C. rules, exemptions, and threshold requirements
- Definitions of C.F.C. income and rules to compute and attribute that income to others
- Rules to prevent or eliminate double taxation occurring within the context of the C.F.C. rules

*“The objective of the C.F.C. rules is to avoid or neutralize cases where groups or individuals create affiliates that may be established wholly or partly for tax reasons in other jurisdictions in order to be repositories of diverted income.”*

<sup>50</sup> O.E.C.D. (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

## **Recommended Actions**

In October 2015, a final report on Action Item 3 was published. As mentioned above, the aim of this report was to provide national legislators and governments with recommendations tailored to avoid B.E.P.S. situations on a C.F.C. context.

Firstly, the O.E.C.D. provides recommendations for developing rules that define what should be deemed a C.F.C. In order to define a C.F.C., the national legislator should (i) consider whether or not a foreign entity could be considered a C.F.C. by determining what type of entities should fall within the scope of the national C.F.C. rules (*i.e.*, corporate entities, transparent entities, and permanent establishments) and (ii) determine whether the parent company located in the legislator's country has sufficient influence or control over the foreign entity by establishing legal and economic controlling tests, or if appropriate, the adoption of a *de facto* test or a more substantial anti-avoidance approach if considered necessary.

The O.E.C.D. recommends that C.F.C. exemptions and threshold requirements be permitted in order to (i) limit the application of C.F.C. rules to situations that present a high risk of B.E.P.S. situations and (ii) avoid a disproportionate administrative burden for taxpayers and national administrations. These recommendations should be reflected in an exemption in the jurisdiction of the controlling shareholder based on the "effective tax rate" of the C.F.C., so that the C.F.C. inclusion rule would not apply when the C.F.C. has an effective rate that is similar to the rate applied in the parent jurisdiction.

The final report on Action Item 3 then focuses on the definition, computation, and allocation of C.F.C. income.

Possible approaches to identifying C.F.C. income that should be attributed to the controlling shareholders include (i) a categorical analysis of the income, (ii) determination of the part of the profit that could be considered to exceed a "normal return" generated by C.F.C.'s located in low tax jurisdictions, and (iii) a case-by-case analysis based on the transactions and entities involved.

Computation of such income should be made under the rules of the parent jurisdiction. These rules should allow for a full offset of C.F.C. losses in order to maintain a comparable treatment between C.F.C. profits and C.F.C. losses that are allocated in the jurisdiction of the controlling entity.

The attribution of C.F.C. income should be consistent with the recommendations dealing with the definition of a C.F.C. and should take into account the percentage and period of ownership within a particular year. C.F.C. income should be treated in accordance with the applicable rules of the parent jurisdiction.

Finally, in acknowledging its historic role, the O.E.C.D. recommends Action Item 3 rules that prevent or eliminate double taxation occurring due to allocations of income under C.F.C. rules.

Double taxation can appear as a result of C.F.C. rules when C.F.C. income is subject to corporation income tax in two or more jurisdictions, or if the same C.F.C. income is targeted by more than one jurisdiction. In these two cases, the O.E.C.D. recommends that a tax credit should be allowed in the parent jurisdiction. For the

avoidance of doubt, this tax credit amount should correspond to all taxes due from the C.F.C. on income that has not qualified for other tax relief but should not exceed the tax amount due on the same income in the parent jurisdiction.

Double taxation can also exist if a C.F.C. actually distributes a dividend from a pool of income that has already been apportioned to the parent company and taxed in its country of residence. In that case, the O.E.C.D. recommends the allowance of an exemption for the actual dividend and a basis increase to reduce or eliminate the gain.

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

### **Focus**

Action Item 4 focuses on the need to address B.E.P.S. using deductible payments, such as interest, that can give rise to double nontaxation in inbound and outbound investment scenarios.<sup>51</sup>

The fact patterns deemed to be abusive are those that allow the use of the following tax-saving devices:

- 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
- A disproportionate level of third-party debt incurred by companies located in high-tax jurisdictions compared to the group overall debt

### **Recommended Action**

Action Item 4 analyzes best practices and recommends an approach, with alternative restricted options to take into consideration local economic circumstances, to address these occurrences of base erosion and profit shifting.

The recommended approach consists of a limitation of the allowed interest deduction with reference to a fixed ratio. Under this scenario, an entity would be able to deduct interest expense up to a specified portion of its earnings before interest, taxes, depreciation, and amortization. This approach is intended to link the amount of deductible net interest to taxable economic activity. Each country's government would thus determine a benchmark fixed ratio which will apply irrespective of the actual leverage of an entity or its group. Interest paid by the entity to third or related parties will be deductible up to this fixed ratio, but any interest above this ratio will be disallowed.

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<sup>51</sup> O.E.C.D. (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report*, O.E.C.D./IG-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

In order to address B.E.P.S. risks, Action Item 4 recommends that countries establish their benchmark fixed ratio in a corridor between 10% and 30%, depending on their legal framework and economic circumstances.

Nevertheless, recognizing that the establishment of a fixed ratio does not cover possible variations in group leverage based on industry practice, the fixed ratio rule should be combined with a group ratio rule. In this scenario, interest above the fixed ratio may still be deductible based on the ratio of the worldwide group (*i.e.*, net third-party interest expense or group E.B.I.T.D.A.). This combination may be included in a separate rule or as part of the general overall provision.

Other suggestions are also proposed in Action Item 4 to tackle the adverse effects of a rigid application of the benchmark ratio approach, such as potential volatility in earnings that impact the ability to deduct interest expense in a particular period. Where that occurs, several safe harbors may apply, such as determining the group ratio rule on an equity-to-total assets ratio (“Equity Escape Rule”), or by using an average E.B.I.T.D.A. over several years, or by carrying interest expense to earlier or later periods.

Therefore, under Action Item 4, the O.E.C.D. remains flexible on the implementation of the recommended approach and additionally offers the opportunity for each country to implement more specific rules in addition to this general approach in order to target any behavior leading to B.E.P.S. Further work on the recommended approach was provided at the end of 2016, including guidance on group ratio rules and specific rules to address the issues raised by the insurance and banking sectors.

## 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 Item 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*,<sup>52</sup> show that the topic has been discussed for many years among the different stakeholders. Action Item 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

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 can be described as follows:

- A multinational group holding I.P. rights has its seat located in a jurisdiction that has no favorable tax regime for I.P. holders.

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<sup>52</sup> O.E.C.D. (1998), *Harmful Tax Competition: An Emerging Global Issue*, O.E.C.D. Publishing, Paris.





- 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 corporation income tax rates.

To address the situation, the M.N.E. interposes a company (“I.P. Co”) located in a jurisdiction that has laws providing a more favorable I.P. regime (“the other jurisdiction”). The I.P. rights are held by I.P. Co, 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 I.P. Co computes its tax under the laws of the other jurisdiction. The group uses the accumulated funds within I.P. Co 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 October 2015, a final report on Action Item 5 was published.<sup>53</sup> In broad terms, Action Item 5 is aimed 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 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 chapter.

As mentioned in the report, the nexus approach is the approach selected to impose a substantial activity requirement 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 gives 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. In other words, income derived from eligible I.P. rights should derive benefits of a favorable tax treatment only in proportion to the research and development expenditures incurred by the taxpayer in relation to the I.P. rights, when compared to global expenditures related to the I.P. rights.

As part of the nexus approach, it has been agreed that countries offering I.P. regimes are required to implement changes ensuring 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 Item 5 will be that I.P. Co will be taxed at full corporate rates in the other jurisdiction on its royalty and license fee income after completion of the five-year grandfathering period, unless it fully staffs the company with personnel performing research and development activities. The other jurisdiction may provide tax and other incentives that are not considered

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<sup>53</sup> O.E.C.D. (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

harmful under Action Item 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 standards of Action Item 5.

The second milestone of Action Item 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 three-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. As a third part, the Forum sets guidelines for countries still using such ruling procedures.

The scope of the automatic exchange of ruling procedure covers six categories of rulings, *viz.*, (i) rulings relating to preferential regimes, (ii) unilateral advance pricing rulings or other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits, (iv) permanent establishment rulings, (v) related-party conduit rulings, and (vi) any other type of ruling which could give rise to B.E.P.S. concerns.<sup>54</sup>

Once information related to the above-listed rulings has been received by the taxpayer's country, this should be further communicated to the countries of residence of all related parties involved in the ruling, and to the country of residence of the ultimate parent company.

Apart from establishing an exhaustive list of rulings falling under the scope of the exchange, the report specifically sets a timeframe and distinguishes past rulings from future rulings. It clearly states that any past rulings that have been issued, modified, or renewed on or after January 1, 2010, and which are still valid on January 1, 2014, will have to be exchanged before the end of 2016. For the future rulings, *i.e.*, rulings issued on or after April 1, 2016, the exchange should take place within three months of the ruling issuance and should be organized between the country granting the ruling, the countries of the immediate parent, the ultimate parent, and the countries of residence of affected related parties.

The information to be exchanged has been listed in a template available as an Annex to the report. This standardized approach will facilitate the exchange of useful information and lower administration costs.

On July 11, 2016, the O.E.C.D. released its standardized electronic file format for the exchange on tax rulings ("E.T.R.") between jurisdictions – the E.T.R. XML Schema – as well as the related guidance documentation ("User Guide") for tax administrations, which were updated in September 2017. The User Guide provides further details on the information that must be reported. It also contains instructions on how to modify data elements within the file.

As mentioned in the report, the E.U. has been working on measures in the field of compulsory exchange of rulings. On December 8, 2015, Council Directive 2015/2376 provided for the automatic exchange of information regarding cross-border tax rulings and advance pricing arrangements with effect from January 1, 2017. The two initiatives move in the same direction in parallel. Such transparency initiatives raise issues that may cause collateral damage if not addressed. One area of concern is the confidentiality of the information received by a country. A second area is the

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<sup>54</sup> *Id.*, p. 46.

**“Since the inception of the B.E.P.S. Project, the F.H.T.P. has reviewed 319 regimes.”**

comparability of the information sent by one country with the information received from another. The tax administrations in some countries may take more time to develop a system that provides the desired level of information.

In a third and final step, the report provides a list of best practices to use in countries where a ruling regime is available. These guidelines include developments on a detailed process for granting rulings, indications in relation to the terms of the ruling, the subsequent audit or checking procedure to be put in place, and a final statement on the publication and exchange of information.

On February 1, 2017, the O.E.C.D. released the *Terms of Reference and Methodology for Peer Reviews*<sup>55</sup> addressing the exchange of information on tax rulings. The peer review and the monitoring process will be conducted by the Forum to ensure the effective implementation of the agreed-upon standards.

All jurisdictions that have committed to implementing the minimum standards of Action Item 5 are subject to a peer review of their implementation.

In January 2019, the O.E.C.D. released the report “Harmful Tax Practices – 2018 Progress Report on Preferential Regimes,”<sup>56</sup> which includes the results of a review of preferential tax regimes since the start of the B.E.P.S. Project. This review was undertaken by the Forum on Harmful Tax Practices (“F.H.T.P.”) in accordance with the B.E.P.S. Action 5 minimum standards. In total, 255 preferential tax regimes were reviewed to ensure compliance with the nexus approach. More than half of these have been amended or abolished. The others were either already compliant with the Action 5 standard or in the process of being reviewed or reformed. As part of ongoing work to revise the existing F.H.T.P. criteria, a new standard, which imposes substantial activities requirements on low or no-tax jurisdictions, was adopted in 2018. In October 2019, the Inclusive Framework released guidance on the framework for the spontaneous exchange of information collected by low or no-tax jurisdictions.

In January 2023, the Inclusive Framework released updated conclusions on the review of preferential tax regimes. Since the inception of the B.E.P.S. Project, the F.H.T.P. has reviewed 319 regimes.

On December 14, 2022, the O.E.C.D. released the 2021 peer review assessments of 131 jurisdictions regarding the spontaneous exchange of information on tax rulings. Over 23,000 tax rulings were identified and almost 50,000 exchanges between jurisdictions took place. Out of the 131 reviewed jurisdictions, 73 jurisdictions did not receive any recommendations, as they have met all the terms of reference. A further 19 jurisdictions received only one recommendation. This is the second review that took place under the renewed peer review process issued on February 22, 2021.

<sup>55</sup> O.E.C.D. (2017), *B.E.P.S. Action 5 on Harmful Tax Practices – Terms of Reference and Methodology for the Conduct of the Peer Reviews of the Action 5 Transparency Framework*, O.E.C.D./IG-20 B.E.P.S. Project, O.E.C.D., Paris.

<sup>56</sup> O.E.C.D. (2019), *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, O.E.C.D./IG-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

## 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 otherwise have been able to claim a comparable benefit to reduce its overall taxable burden.

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

The B.E.P.S. Action Plan has identified treaty abuse, and particularly treaty shopping, as one of the most important sources of base erosion and profit shifting. The Final Recommendations on Action Item 6<sup>57</sup> make a distinction between two types of treaty abuse:

- Abuse of the tax treaty itself
- 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 and the following amendments to the Model Tax Convention:

- The 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 nontaxation or reduced taxation.
- The inclusion in tax treaties of a specific anti-abuse rule based on the limitation on benefits (“L.O.B.”) provisions, as are already provided in treaties concluded by the United States and a few other countries.
- The addition to tax treaties of a more general anti-abuse rule (“G.A.A.R”) based on the principal purpose test (“P.P.T.”) to address other forms of treaty abuse.<sup>58</sup>

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 non-collective investment vehicle

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<sup>57</sup> O.E.C.D. (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

<sup>58</sup> *Id.*

“non-C.I.V.” funds<sup>59</sup> would not qualify under the L.O.B. rules, as they do not meet any of the proposed requirements.<sup>60</sup> Regarding their particular activity, discussions are taking place to determine whether these non-C.I.V. 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.<sup>61</sup>

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.”<sup>62</sup>

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

In addition, the wording of G.A.A.R. provisions raise 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.<sup>63</sup>

Thus, the report recognizes that flexibility may be required in the adoption of the suggested rules in relation to domestic anti-abuse regimes, constitutional issues, policy choices, and E.U. laws.<sup>64</sup>

As a minimum standard, countries are expected to include in tax treaties an express statement regarding the common intention to avoid creating opportunities for non-taxation or reduced taxation and to carry out that intention by (i) a combined L.O.B. rule with a P.P.T. rule, (ii) the P.P.T. rule, or (iii) the L.O.B. rule complemented by an anti-conduit arrangement rule.

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<sup>59</sup> The term “C.I.V.” appears to be limited to funds that are widely held, hold a diversified portfolio of securities, and are subject to investor protection regulation in the country in which they are established. In this context, non-C.I.V. funds should refer, *inter alia*, to alternative funds, pension funds, and sovereign wealth funds.

<sup>60</sup> O.E.C.D. (2015), *Revised Discussion Draft, B.E.P.S. Action 6: Prevent Treaty Abuse*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

<sup>61</sup> O.E.C.D. (2016), *Public Discussion Draft, Treaty Entitlement of Non-C.I.V. Funds*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing.

<sup>62</sup> O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*.

<sup>63</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995.

<sup>64</sup> O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, p. 19, ¶¶21-22.

The second type of abuse analyzed by Action Item 6 addresses situations where treaties prevent the application of specific domestic laws targeting abuses such as domestic G.A.A.R., thin capitalization, C.F.C. diversions of income, exit or departure taxes, and similar provisions. Aside from the inclusion of new commentaries in the O.E.C.D Model Tax Convention on these issues and in relation to the new P.P.T. rule aimed at maintaining the application of domestic anti-avoidance rules, Action Item 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 tax treaty. As the O.E.C.D. pointed out, such a provision could clearly lead to double taxation and thus, would require further work in the first part of 2016. Additionally, Action Item 6 addresses the issue of exit or departure taxes by confirming that clarification will be made to the commentary on the O.E.C.D. Model Tax Convention to maintain domestic application.

The multilateral instrument mandated by the O.E.C.D. members and G-20 is intended to implement the various anti-abuse rules included in Action Item 6.

The latest edition of the O.E.C.D. Model Tax Convention of November 2017 notably reflects the treaty-related recommendations under Action Item 6 of the B.E.P.S. Action Plan.

Since 2019, the O.E.C.D. has released peer review reports assessing the implementation of the Action 6 minimum standards annually.

In April 2021, the O.E.C.D. released the Revised Peer Review Documents including the Terms of Reference which set out the criteria for assessing the implementation of the minimum standard and the methodology which sets out the procedural mechanism by which the review will be conducted.

The peer review published on March 21, 2023, reveals that a large majority of Inclusive Framework members have modified, or are in the process of modifying, their treaty networks and that the M.L.I., which implements the treaty related B.E.P.S. measures, appears to be the preferred tool.

In January 2024, the O.E.C.D. released an updated version of the revised peer review documents which it originally released in 2021. It includes the terms of reference which set out the criteria for assessing the implementation of the minimum standard and the methodology which sets out the procedural mechanism by which the review will be conducted.

The latest peer review, published by the O.E.C.D. in March 2024, indicates that a large majority of the Inclusive Framework Members have modified, or are in the process of modifying, their treaty network to implement the minimum standard and other B.E.P.S. treaty-related measures.

## **B.E.P.S. ACTION 15: MULTILATERAL INSTRUMENT**

### **Scope of the M.L.I.**

The M.L.I. implements a number of treaty-related measures recommended by the B.E.P.S. Action Plan.

*“Since 2019, the O.E.C.D. has released peer review reports assessing the implementation of the Action 6 minimum standards annually.”*

The purpose of the M.L.I. is to implement the treaty-related minimum standards in a swift, coordinated, and consistent manner across the network of existing tax treaties without the need to bilaterally renegotiate each tax treaty. The M.L.I. is flexible enough to accommodate the positions of different countries and jurisdictions through the use of certain opt-in or opt-out mechanisms that are mandatory unless the relevant treaty already meets the minimum standards. It also includes provisions that go beyond the minimum standards, which may or may not be implemented at the option of the countries involved.

The M.L.I. directly amends all bilateral tax treaties that are in force between the signatory states. Each state must, however, provide the O.E.C.D., which is the Depository for the M.L.I., with a list of the treaties to be covered (“Covered Treaties”), as well as the options that were implemented by the relevant state in the Covered Treaties.

The treaty-related measures of the B.E.P.S. Project include Action Item 2 on hybrid mismatches, Action Item 6 on treaty abuse, Action Item 7 on the artificial avoidance of the permanent establishment status, and Action Item 14 on dispute resolution and arbitration. Only Action Item 6, the P.P.T., and the dispute resolution mechanism under the mutual agreement procedures are required by the minimum standards.

## **Main Provisions of the M.L.I.**

### *Hybrid Mismatches*

Article 3 of the M.L.I. provides for certain rules regarding so-called hybrid mismatches, in particular in regard to (i) tax transparent entities, (ii) dual residence, and (iii) the elimination of double taxation. These provisions are optional and hence the implementation thereof depends on each of the Contracting States.

### Transparent Entities

Article 3.1 of the M.L.I. introduces a new rule for the application of a tax treaty to the income derived from tax transparent entities. Accordingly, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State is considered income of a resident of a Contracting State only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

As an example, assume that State A and State B have implemented Article 3.1 of the M.L.I. A Borrower resident in State A pays interest to a wholly or partly tax transparent Lender established in State B. State A considers the Lender established in State B to be a company and that State B will tax the Lender on the interest that it receives from the Borrower in State A. State B, however, treats the Lender as a partnership, and the two partners who share the partnership’s income equally are each taxed on half the income. One of the partners is resident in State B and the other is resident in a State that has not concluded a tax treaty with either State A or State B. According to Article 3.1 of the M.L.I., half of the interest is considered income of a resident of State B.

### Dual Resident Entities

In cases where a party other than an individual is a resident of both Contracting States, Article 4 of the M.L.I. provides that the competent authorities must determine



the residence of the person by mutual agreement using a tie-breaker that takes into account the place of effective management, the place of incorporation, and any other relevant factors. In the event that no mutual agreement can be reached, the party is not entitled to any tax relief or exemption provided by the tax treaty, except to the extent that and in such a manner as is agreed upon by the competent authorities.

### Elimination of Double Taxation

Contracting States may choose to implement one of the three optional methods for the elimination of double taxation. The alternatives are outlined in Article 5 of the M.L.I.:

- Under Option A, provisions of a Covered Treaty that would otherwise exempt income derived by, or capital owned by, a resident of a Contracting State from tax in the other Contracting State do not apply if the other Contracting State also applies the treaty to exempt such income or capital from tax or to limit the rate of taxation thereof. In the latter case, a tax credit should be granted by the state of residence.
- Under Option B, provisions of a Covered Treaty that exempt dividend income derived by a resident of a Contracting State from tax in the other Contracting State do not apply if such income gives rise to a deduction for the payor resident in the other Contracting State. In this case, a tax credit should be granted for the income tax paid in the source state.
- Under Option C, each Contracting State exclusively uses the credit method to eliminate double taxation for its residents.

### Treaty Abuse

#### Minimum Standards

Article 6 of the M.L.I. requires Covered Treaties to introduce the minimum standard for protection against tax treaty abuse as an express statement using the following text as part of the preamble to the treaty:

Intending to eliminate double taxation with respect to the taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions)

It should be noted that the inclusion of this language is itself a minimum standard and hence mandatory. This provision further allows a Contracting State to apply its domestic general anti-abuse rules to a given transaction.

#### P.P.T. and L.O.B.

The provisions based on Action Item 6 include three alternatives for addressing situations of treaty abuse:

- The first is a P.P.T.
- The second is a P.P.T. and an L.O.B. provision.



- The third is a detailed L.O.B. provision supplemented by a mechanism to deal with conduit arrangements not already addressed in the treaty.

Under the P.P.T., a benefit of a Covered Treaty will be denied if, considering all relevant facts and circumstances, it is reasonable to conclude that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is in accordance with the object and purpose of the relevant treaty provisions.

The P.P.T. may be supplemented by an L.O.B. clause. The M.L.I. does not provide for a standard detailed L.O.B. as outlined in the Final Report on Action Item 6, but merely states that a detailed L.O.B. clause may be agreed on bilaterally. As a result, only a simplified L.O.B. clause is included in the M.L.I., which provides that the benefits of a Covered Treaty are only accessible to a “qualified person” unless the person is engaged in the active conduct of a business. A qualified person must fulfill certain requirements proving a sufficiently strong link with the claimed state of residence in order to receive benefits under the Covered Treaty.

The detailed L.O.B. clause described in the Final Report of Action Item 6 also addressed C.I.V. funds, but since these provisions were not introduced into the M.L.I., uncertainty regarding their treatment persists. Similarly, the application of the P.P.T. or the L.O.B. clause in respect to non-C.I.V. funds has not been addressed by the M.L.I. or the explanatory statements. However, a consultation document tackling this issue was released in early 2017 by the O.E.C.D., confirming that the O.E.C.D. is continuing to examine issues relating to non-C.I.V. funds and plans to ensure that the new treaty provisions included in the B.E.P.S. Report on Action Item 6 adequately address the treaty entitlement of these funds. Accordingly, a separate report is expected to be released by the O.E.C.D. in the future.

#### Dividend Transfer Restriction

The M.L.I.’s dividend transfer restriction is based on Article 10(2) of the O.E.C.D. Model Tax Convention of the Action Item 6 Report. It introduces a minimum shareholding period of 365 days (including the day of the payment of the dividends) to a Covered Treaty’s existing provisions without changing the substantive allocation of taxation rights between the Contracting States.

#### Capital Gains Derived Indirectly from Real Estate

The M.L.I. bases its treatment of capital gains derived indirectly from real estate on Article 13(4) of the O.E.C.D. Model Tax Convention as revised by the Action Item 6 Report.

According to Article 13(4) of the O.E.C.D. Model Tax Convention, gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other state. In order to avoid situations where assets are contributed to an entity shortly before a sale of its shares or comparable interests in order to dilute the proportion of the entity’s value that is derived from immovable property, the M.L.I. (i) introduces a testing period for determining whether the value threshold is met and (ii) expands the scope of covered interests to include interests comparable to shares, such as interests in a partnership or trust. Accordingly, the relevant provisions allowing the source state to tax such capital gains may continue to apply if the relevant value threshold is met at any time during

the 365 days preceding the alienation, and may apply not only to shares but also to comparable interests, such as interests in a partnership or trust.

### Anti-Abuse Rule for Exempt or Low-Taxed Permanent Establishments

Article 10 of the M.L.I. addresses cases where an enterprise in one Contracting State derives income from the other Contracting State, and the first Contracting State treats the income as exempt income attributable to a permanent establishment of the enterprise situated in a third jurisdiction.

### Saving Clause

The M.L.I. provides for a “saving clause” that preserves the right of a Contracting State to tax its own residents. Therefore, a tax treaty will not affect the taxation by a Contracting State of its own residents, except with respect to the benefits granted under the provisions of the tax treaty, such as the double tax relief article.

### Avoidance of Permanent Establishment Status

In accordance with the objective of Action Item 7, the M.L.I. aims to amend existing tax treaties to counter the artificial avoidance of permanent establishment status through various methods, described below.

### Commissionaire Arrangements

A commissionaire arrangement is one in which an independent agent, or commissionaire, sells products in a state under its own name but on behalf of a foreign enterprise. Under the current definition of “permanent establishment” in the O.E.C.D. Model Tax Convention, an enterprise is able to use a commissionaire arrangement to avoid having a permanent establishment in the state where the sale actually occurs, while the commissionaire, not being the owner of the assets, only receives remuneration for his services.

This practice has been considered abusive by the O.E.C.D., and hence Article 13 of the M.L.I. amends the definition of permanent establishment to include independent agents who act on behalf of a foreign enterprise and habitually play the principal role in the conclusion of contracts without any material modification by the enterprise.

This amendment is optional for the Contracting States.

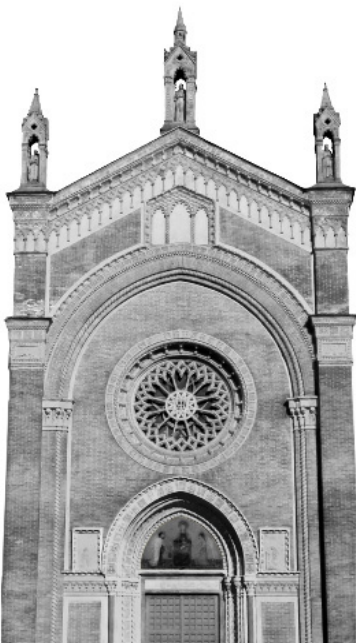
### Specific Activity Exemptions

The work on Action Item 7 led to changes to the wording of Article 5(4) of the O.E.C.D. Model Tax Convention to address situations in which specific activity exemptions give rise to B.E.P.S. concerns. Under the new wording, the activities listed in Article 5(4) will only be deemed not to constitute a permanent establishment if they are of a preparatory or auxiliary character.

This amendment is optional for the Contracting States.

### Splitting-Up of Contracts

According to the O.E.C.D.’s Final Report on Action Item 7, the segmentation of contracts is another potential strategy for the artificial avoidance of permanent establishment status. The M.L.I. therefore amends the existing 12-month threshold for



determining the existence of a permanent establishment to take into account any activities carried out by an enterprise in a jurisdiction during one or more periods of time, which when aggregated, exceed 30 days within the 12-month threshold.

### Implementation of Action 7 Through the M.L.I.

In July 2020, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. published a progress report covering July 2019 through July 2020.<sup>65</sup> According to this report, of the 94 jurisdictions that were party to the M.L.I. in June 2020,

- 46 jurisdictions have opted for the changes to Article 5(5) and 5(6) of the O.E.C.D. Model Tax Convention, lowering the threshold for the creation of a dependent agent permanent establishment;
- 55 jurisdictions have opted for the amended Article 5(4) of the O.E.C.D. Model Tax Convention, with the preparatory or auxiliary requirement;
- 54 jurisdictions have opted for the anti-fragmentation rule in Article 5(4.1) of the O.E.C.D. Model Tax Convention; and
- 34 jurisdictions have opted for the anti-contract splitting provision included in the Commentary on Article 5 of the O.E.C.D. Model Tax Convention.

### Dispute Resolution and Arbitration

The M.L.I. provides methods for the implementation of a minimum standard for improving dispute resolution, which were developed in Action Item 14.

If a taxpayer considers that the actions of one or both Contracting States result or will result in taxation not in accordance with the provisions of the tax treaty, the taxpayer may present its case to the competent authority of either Contracting State. However, the case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the tax treaty. Both Contracting States should endeavor to resolve the case by mutual agreement with a view to the avoidance of the tax measure that is supposedly inappropriate and for that reason is under dispute. Any agreement reached shall be implemented without a time limit.

Article 17 of the M.L.I. introduces a mandatory corresponding adjustment of tax charged on profits in one Contracting State in cases where the other Contracting State has included a portion of those taxable profits under applicable transfer pricing rules.

An optional clause for mandatory binding arbitration is contained in the M.L.I. that would allow participating countries to limit the cases eligible for arbitration based on reciprocal agreements.

The minimum standard is subject to a peer review process. As of May 2019, 45 jurisdictions had been reviewed and around 990 recommendations for improvement have been issued to these jurisdictions. The monitoring process (*i.e.*, stage 2) is underway. As of April 14, 2022, 82 Stage 1 peer review reports and 69 Stage 1 and Stage 2 peer monitoring reports have been published.

<sup>65</sup> O.E.C.D. (2020), *O.E.C.D./G20 Inclusive Framework on BEPS: Progress report July 2019 – July 2020*.

*“The M.L.I. provides methods for the implementation of a minimum standard for improving dispute resolution, which were developed in Action Item 14.”*

### Reservations

No reservations may be made to the M.L.I. except those expressly permitted. However, the M.L.I. accepts that in most cases a Contracting State will assert some reservations.

### Timing

The M.L.I. has been open for signature since December 31, 2016. A formal signing ceremony was held in Paris on June 7, 2017. Following signature, Contracting States must complete the domestic procedures necessary to ratify the M.L.I.

Following ratification, the Contracting States must notify the Depository and provide a list of Covered Treaties and options.

The M.L.I. will then enter into force between the Contracting States on the first day of the month following the expiration of a period of three calendar months, beginning on the date when notification of ratification was deposited with the O.E.C.D.

The provisions of the M.L.I. will then affect a Covered Treaty with respect to

- taxes withheld at the source on the first day of the next calendar year that begins on or after the date on which the M.L.I. entered into force between the Contracting States; and
- all other taxes for taxable periods following the expiration of a period of generally six calendar months after the date on which the M.L.I. entered into force between the Contracting States.

As of May 31, 2024, out of the 102 jurisdictions that are currently a party to the M.L.I., 85 have deposited instruments of ratification.

### Conclusion

One important question that remains is whether the M.L.I. will lead to increased consistency or add further complexity to the international tax system. Considering the M.L.I.'s flexibility and various available options, it is possible that its application will be highly complex and lead to uncertainty. Such flexibility may even be contrary to the idea of countering B.E.P.S. in a comprehensive and coordinated manner. However, considering the massive variation across global economies and politics, it seems impossible to compose one set of tax treaty provisions that would accommodate all states in the foreseeable future. Therefore, without a doubt, differences across treaty texts will remain.

Nonetheless, implementing these provisions through the M.L.I. rather than bilateral negotiation enables the minimization of differences across treaty texts and the harmonization of the interpretation and application of tax treaties.

## CONCLUDING REMARKS ON THE E.U.'S ACTION

The E.U. has been addressing the B.E.P.S. Action Plan through the adoption of several E.U. directives in a wide and coordinated response to the O.E.C.D.'s recommendations.

In this respect, the E.U. has already adopted the following directives:

- E.U. Council Directive 2015/2376 on the automatic exchange of cross-border rulings or advance pricing arrangements (in response to Action Item 5),
- E.U. Council Directive 2016/881 on the reporting by multinational companies of specified tax-related information, along with the exchange thereof, between E.U. countries (in response to Action Item 13), and
- E.U. Council Directive 2016/1164 and E.U. Council Directive 2017/952, known as the Anti-Tax Avoidance Directives (“A.T.A.D.”).

It is noteworthy that the measures included in the A.T.A.D. follow the principles set out by the B.E.P.S. Report in regard to

- hybrid mismatches (Action Item 2),
- C.F.C. rules (Action Item 3),
- limitation on interest deductions (Action Item 4), and
- the G.A.A.R. (Action Item 6).

On May 29, 2017, the E.U. Council adopted a directive to amend the A.T.A.D. (“A.T.A.D. 2”) in order to extend the scope of the provisions on hybrid mismatches from E.U. Member States to include third countries and align the A.T.A.D. with the recommendations of Action Item 2. The A.T.A.D. not only implements the B.E.P.S. Project’s minimum standards, but even surpasses them with the addition of exit taxation and the use of broader definitions.

On March 21, 2018, the E.U. Commission proposed two additional directives on the taxation of digital business activities to implement Action Item 1 of the B.E.P.S. Action Plan. The first proposal lays down rules relating to the corporate taxation of a significant digital presence, while the second proposal provides for the introduction of a common system of digital services taxation for revenues resulting from the performance of certain digital services. On March 12, 2019, the E.U. Council failed to reach an agreement on an E.U. digital services tax, which was based on a new compromise limiting the scope to digital advertising services.

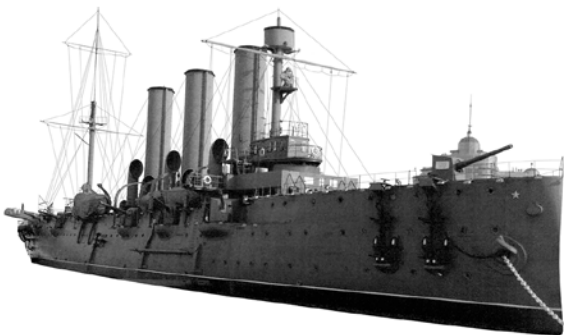
The E.U. Commission’s more recent effort to build on the O.E.C.D. GloBE rules discussed above has been more successful: its December 2021 proposal to ensure a global minimum level of taxation for multinational enterprises within the E.U. and to expand the scope of the GloBE rules to domestic groups was adopted by the Council of Ministers in December 2022 and is now known as the E.U. Minimum Tax Directive (2022/2523).

The E.U. Minimum Tax Directive required the Member States to transpose the rules into domestic law by December 31, 2023. Essentially, this means that the GloBE rules are now transposed into E.U. secondary law, meaning that the global minimum effective rate of corporate taxation, at an agreed minimum rate of 15%, now applies to multinational enterprises as well as large-scale domestic groups based in the E.U.

Furthermore, on September 12, 2023, the E.U. Commission published two proposals for a Council Directive, both intended to reduce tax compliance costs for large, cross-border businesses in the E.U.

The first proposal concerns the Council Directive on Business in Europe: Framework for Income Taxation (“B.E.F.I.T.”). This introduces a common corporate tax framework to compute the taxable base at the level of a single entity of the relevant group company. These tax bases are then aggregated at the E.U. group level and ultimately reallocated to the relevant E.U. Member States. If the B.E.F.I.T. Directive is adopted, it is scheduled to come into force on July 1, 2028.

In addition to its B.E.F.I.T. proposal, the European Commission published a separate Council Directive proposal on transfer pricing (the “T.P. Directive”), which essentially builds on the O.E.C.D. Transfer Pricing Guidelines. If the Member States reach an agreement on this T.P. Directive, it would enter into force on January 1, 2026. If adopted, both proposals will have to be implemented by each Member State. As all Directives related to tax, adoption of the Directive will require unanimous approval by the E.U. Member States.



# EUROPEAN TAX LAW

**Author**  
Matthias Scheifele  
Hengeler Mueller  
Munich, Germany

Because each of the E.U. Member States is free to decide its own economic policy and direct taxes are not harmonized across the E.U., there is strong tax competition within the E.U. market. Efforts to ensure a level playing field with respect to direct taxation have sparked several initiatives at the E.U. level. Currently, the discussion focuses on the key issues of State Aid, transparency measures, reporting standards, and most recently, measures aimed at combatting tax avoidance. Also, in recent years, the E.U. has recognized the need to simplify European tax law and reduce compliance costs.

## STATE AID

### **Legal Framework and Definition of “State Aid”**

Pursuant to Article 107 §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 trade between Member States. A measure qualifies as “State Aid” if it falls under the following criteria:

- The relevant intervention is granted by a Member State or through state resources.<sup>1</sup>
- The intervention provides an economic advantage to the recipient.<sup>2</sup>
- The intervention distorts or threatens to distort competition and affects or may affect trade between the Member States.<sup>3</sup>
- The advantage is selective, *i.e.*, it is only granted to specific recipients.

Even if a measure meets the foregoing criteria, to be considered State Aid within the meaning of Article 107 §1 T.F.E.U., it may not be unlawful if one of the exemptions provided in Article 107 §§2 or 3 T.F.E.U. applies. For example, State Aid may be compatible with the internal market if it has a social character and is granted to individual consumers, eliminates damages caused by natural disasters or exceptional

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<sup>1</sup> Commission Notice, 1998 O.J. C 384/03, ¶10 [hereinafter “State Aid and Direct Business Taxation”]; replaced by Commission Notice, 2016 O.J. C 262/01, ¶47 [hereinafter “State Aid in the T.F.E.U.”].

<sup>2</sup> State Aid in the T.F.E.U., ¶66.

<sup>3</sup> *Id.*, ¶185; according to the European Commission, these are two distinct elements, even, however, they are often treated jointly (State Aid in the T.F.E.U., ¶186).

occurrences.<sup>4</sup> In addition, the following may also be considered to be compatible with the internal market:<sup>5</sup>

- Aid to promote the economic development of certain areas<sup>6</sup>
- Aid promoting the execution of projects of common interest or to remedy serious disturbances in the economy of a Member State<sup>7</sup>
- Aid to facilitate the development of certain economic activities or areas without affecting trading conditions<sup>8</sup>
- Measures promoting culture and heritage conservations without affecting trading conditions and competition<sup>9</sup>
- Other categories of aid as specified by decision of the European Council upon proposal by the European Commission<sup>10</sup>

Article 108 §3 T.F.E.U. provides that if a Member State intends to implement a new State Aid measure, it must notify the Commission. Pursuant to Article 108 §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 the review of existing State Aid or the recovery of unlawful State Aid. However, Article 109 T.F.E.U. authorizes the Council (upon proposal by the Commission and after consulting the Parliament) to implement regulations deemed appropriate regarding the application of the State Aid provisions, which the Council did in adopting Council Regulation 2015/1589/E.U. (the “Procedural Regulation”).<sup>11</sup>

Pursuant to the Procedural Regulation, the Commission decides whether a proposed measure constituting State Aid is compatible with the internal market.<sup>12</sup> After notice but prior to the Commission’s authorization, proposed State Aid measures must not be put into effect.<sup>13</sup> If the Commission finds that existing State Aid is incompatible with the internal market, it must decide whether the Member State granting the State Aid should amend or abolish the measure within a period of time as

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<sup>4</sup> Consolidated Version of the Treaty on European Union art. 107, 2012 O.J. C 326/47, §2 [hereinafter “T.F.E.U.”]; The Commission views the COVID-19 outbreak as an exceptional occurrence; Commission Press Release, IP/20/454 (March 12, 2020).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*, §3(a).

<sup>7</sup> *Id.*, §3(b). In particular, this exemption was of importance in the context of the financial crises. See also *Blumenberg/Kring*, IFSt Nr. 473, 2011, p. 21(f). Also in the context of the COVID-19 outbreak, a State Aid Temporary Framework to support the economy is based on this exemption; Commission Press Release, IP/20/570 (April 3, 2020) and STATEMENT/20/479 (March 17, 2020).

<sup>8</sup> *Id.*, §3(c).

<sup>9</sup> *Id.*, §3(d).

<sup>10</sup> *Id.*, §3(e).

<sup>11</sup> Council Regulation 2015/1589/E.U. on the Application of Article 108 of the T.F.E.U. (codification), 2015 O.J. L 248/9.

<sup>12</sup> *Id.*, art. 9.

<sup>13</sup> *Id.*, art. 3.



determined by the Commission.<sup>14</sup> State Aid must be recovered from the beneficiary unless the recovery of the aid would be contrary to a general principle of E.U. law.<sup>15</sup>

### **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.”<sup>16</sup> As a consequence, national provisions regarding direct business taxation may be considered State Aid if the definitional criteria of the T.F.E.U. are met. In 1998, the Commission clarified these criteria with respect to national tax provisions in the Commission Notice on the application of State Aid rules to measures relating to direct business taxation.<sup>17</sup> This notice was replaced by the Commission Notice on the notion of State Aid in 2016, which is not limited to tax measures but applies to all types of State Aid.

### **Economic Benefit**

According to the Commission Notice, a tax measure grants an economic benefit within the meaning of Article 107 §1 T.F.E.U. if it relieves the beneficiary of charges it normally should bear. For instance, an advantage could be provided through a reduction in the tax base by special deductions or depreciation or by setting up 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 advantages.<sup>18</sup> In a 2016 notice, the Commission especially addressed advantages in the form of (i) preferential tax regimes for cooperative societies, (ii) special tax rules governing investment funds, (iii) tax amnesties, (iv) tax rulings and settlements, (v) depreciation and amortization rules, (vi) fixed basis tax regimes for specific activities, (vii) exceptions from anti-abuse-rules, and (viii) excise duties.<sup>19</sup>

### **Benefit Through State Resources**

With respect to taxes, an economic benefit can be identified as having been provided by state resources if the tax measure results in a loss of tax revenue. A positive transfer of funds does not have to occur.<sup>20</sup> This applies even if the tax-related State Aid may have an indirect positive overall effect on budget revenue.<sup>21</sup> State support need not be provided only by legislation. It may be provided through the practices of tax authorities.<sup>22</sup>



<sup>14</sup> T.F.E.U., art. 108, §2.

<sup>15</sup> Procedural Regulation, art. 16, §1.

<sup>16</sup> State Aid and Direct Business Taxation, ¶2.

<sup>17</sup> *Id.*, *et seq.*

<sup>18</sup> *Id.*, ¶9.

<sup>19</sup> State Aid in the T.F.E.U., ¶156 *et seq.*

<sup>20</sup> *Id.*, ¶51

<sup>21</sup> Commission Communication Report on the Implementation of the Commission Notice on the Application of State Aid Rules to Measures Relating to Direct Business Taxation, C(2004) 434/1, ¶19.

<sup>22</sup> State Aid and Direct Business Taxation, ¶10.

### Negative Impact on Trade and Competition

The distortion of competition and the effect on trade are two distinct criteria, which are often treated jointly in the assessment of State Aid. According to the Commission, a distortion of competition exists when the State grants a financial advantage to an undertaking in a liberalized sector where there is, or could be, competition.<sup>23</sup> Regarding the effect on trade, it is not relevant if the aid has an actual effect on trade between Member States but only whether the aid is liable to affect such trade.<sup>24</sup>

### Selectivity

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

A measure is selective if it favors certain undertakings or the production of certain goods.<sup>25</sup> Therefore, measures of purely general application, which do not favor certain undertakings, cannot be seen as selective. However, even interventions which, at first appearance, apply to undertakings in general may be selective to a certain extent.<sup>26</sup>

Regarding generally applicable measures which mitigate the charges that undertakings would normally have to bear, e.g., tax exemptions for undertakings fulfilling certain criteria, the selectivity is determined by a three-step-analysis. As a first step, the system of reference must be identified. Second, it should be determined whether a given measure constitutes a derogation from that system insofar as it differentiates between economic operators who, in light of the objectives intrinsic to the system, are in a comparable factual and legal situation. If a measure does constitute a derogation, it is *prima facie* selective. In a third step, it has to be determined, whether the derogation is justified by the nature or the general scheme of the (reference) system.<sup>27</sup> The E.C.J. recently underlined the importance of determining the system of reference solely by looking at national tax law for the reason of recognizing each Member State's tax autonomy. Outside the spheres in which E.U. tax law has been harmonized, only the national law applicable in the Member State concerned must be considered to identify the reference system. In the underlying case, this would have required examining at the detailed application of transfer pricing methods in Luxembourg rather than applying O.E.C.D. Guidelines.<sup>28</sup>

The meaning of this provision and the interpretation of its requirements are unclear, as no official guidance is provided on the way the “nature” or the “general scheme” of a tax system is identified.<sup>29</sup> 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.”<sup>30</sup>

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<sup>23</sup> *Id.*, 187.

<sup>24</sup> *Id.*, 190.

<sup>25</sup> *Id.*, ¶117.

<sup>26</sup> *Id.*, ¶118.

<sup>27</sup> *Id.*, ¶128.

<sup>28</sup> E.G.C., Judgment of November 8, 2022, C-885/19 P and C-898/19 P.

<sup>29</sup> *Jestaed* in Heidenhain, European State Aid Law, 2010, §8 ¶19.

<sup>30</sup> State Aid in the T.F.E.U., ¶138.

Since the Commission replaces one ambiguous term with another vague description, only the case law provides concrete guidance regarding what may qualify as acceptable justification.

With respect to the nature or the general scheme of an identified tax system, the Commission holds, that progressive tax rates are justified by the redistributive purposes of income taxes. Furthermore, the need to fight fraud or tax evasion or the need to avoid double taxation are basis for a possible justification.<sup>31</sup> In any case, the Member States are required to provide the Commission with a justification for the deviations during the notification procedure or the examination of potentially unlawful State Aid.<sup>32</sup>

The Commission Notice of 2016 contains comments on specific issues concerning tax measures with regard to the selectivity,<sup>33</sup> e.g. for tax amnesties,<sup>34</sup> tax rulings and settlements<sup>35</sup> as well as for depreciation and amortization rules<sup>36</sup> and fixed basis tax regime for specific activities.<sup>37</sup>

### **Recovery of Unlawful State Aid**

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

The Commission may only refrain from requiring the recovery of unlawful State Aid in two defined cases. Article 14 §1 of the Procedural Regulation provides that no recovery will be required if it would be contrary to a general principle of E.U. law. These general principles provide for an exemption if, for instance, the recovery is absolutely impossible,<sup>38</sup> or if the protection of the doctrine of legitimate expectation overrides the need for recovery.<sup>39</sup> These exemptions are rarely applicable. Further, the recovery of unlawful State Aid is subject to a limitation period of ten years.<sup>40</sup>

Apart from these exceptions and pursuant to Article 16 §1 of the Procedural Regulation, Member States must take all necessary measures to recover the unlawful State Aid from the beneficiary, including interest on the deferred payment.<sup>41</sup> 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.

**“The Commission may only refrain from requiring the recovery of unlawful State Aid in two defined cases.”**

<sup>31</sup> *Id.*, ¶139.

<sup>32</sup> *Id.*, ¶141.

<sup>33</sup> *Id.*, ¶156 *et seq.*

<sup>34</sup> *Id.*, ¶164 *et seq.*

<sup>35</sup> *Id.*, ¶169 *et seq.*

<sup>36</sup> *Id.*, ¶177 *et seq.*

<sup>37</sup> *Id.*, ¶181 *et seq.*

<sup>38</sup> *Sinnaeve* in Heidenhain, European State Aid Law, 2010, §32, ¶26.

<sup>39</sup> *Id.*, §32, ¶24.

<sup>40</sup> Procedural Regulation, art. 17, §1.

<sup>41</sup> *Id.*, art. 16, §2.

According to case law decided by the E.C.J., national procedural law must be interpreted in a way that does not negatively affect the enforcement of E.U. law (known as the “Supremacy of Community Law”).<sup>42</sup> Therefore, national rules providing that an administrative decision cannot be appealed after the expiration of a limitation period<sup>43</sup> or that suspend the effect of the Commission’s decision for recovery are not applicable and will not override the obligation to obtain a refund of unlawful State Aid.<sup>44</sup>

## **Illustrative Examples**

### **In General**

In the past few years, tax provisions have been subject to increasingly rigorous scrutiny as to whether they constitute State Aid. Investigations in the context of international business taxation suggest that the European Commission views aggressive tax planning and tax base erosion by large multinationals as examples of State Aid.<sup>45</sup> Targets of these investigations include aid to (i) Apple granted by Ireland,<sup>46</sup> (ii) Starbucks granted by the Netherlands,<sup>47</sup> and (iii) Fiat granted by Luxembourg.<sup>48</sup>

In those cases, the European Commission decided that Luxembourg and the Netherlands granted selective tax advantages to Fiat and Starbucks, respectively, by way of tax rulings which confirmed transfer pricing arrangements. These rulings qualify as State Aid because the calculation of intercompany prices did not comply with market terms. By approving the arrangements, the Member States afforded an economic benefit to the companies, but not their competitors, which allowed the companies to allocate profits to low-tax jurisdictions.

In its decisions, the Commission set out the methodology to be used to calculate the value of the undue competitive advantage enjoyed by Fiat and Starbucks, *i.e.*, the difference between what the company paid and what it would have paid without the tax ruling. This amount was estimated to be between €20 million and €30 million for each company. The precise amount of tax to be recovered must now be determined by the Luxembourg and Dutch tax authorities.<sup>49</sup>

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<sup>42</sup> *Land Rheinland-Pfalz v. Alcan Deutschland*, Case C-24/95, [1997] E.C.R. I-01591.

<sup>43</sup> *Id.*, ¶38.

<sup>44</sup> *Commission v. France*, Case C-232/05, [2006] E.C.R. I-10071.

<sup>45</sup> Commission Press Release, IP/14/663 (Jun. 11, 2014).

<sup>46</sup> Commission Decision No. 2017/1283/E.U. (*Apple*), 2016 O.J. L 187/1. See also *Ireland v. Commission*, Case T-778/16 (pending case); *Apple Sales International and Apple Operations Europe v. Commission*, Case T-892/16 (pending case). E.G.C. Judgment of July 15, 2020, T-778/16 and T-892/16; Appeal Case before the E.C.J., C-465/20 P.

<sup>47</sup> Commission Decision No. 2017/502/E.U. (*Starbucks*), 2015 O.J. L 83/88. See also *Netherlands v. Starbucks and Starbucks Manufacturing Emea v. Commission*, Joined Cases T-760/15 & T-636/16, [2019] ECLI:EU:T:2019:669.

<sup>48</sup> Commission Decision No. 2016/2326/E.U. (*Fiat*), 2015 O.J. L 351/1. See also *Luxembourg and Fiat Chrysler Finance Europe v. Commission*, Joined Cases T-759/15 & T-755/15, [2019] ECLI:EU:T:2019:670.

<sup>49</sup> *State Aid to Fiat*, 2015 O.J. L 351/1; *State Aid to Starbucks*, 2015 O.J. L 83/38.

**“In the case of Apple, the Commission argued that the transfer prices used were negotiated with Irish tax authorities 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.”**

### Appeals by Starbucks and Fiat

In September 2019, the General Court (“E.G.C.”) annulled the European Commission’s decision regarding Starbucks,<sup>50</sup> whereas it confirmed the decision with respect to Fiat.<sup>51</sup> In both cases, the arm’s length principle was found to be an appropriate State Aid standard for determining whether a selective advantage was given to a particular company. If the Commission can demonstrate that a ruling allowed a company to depart from an arm’s length determination of income, the ruling constitutes unlawful State Aid. In comparison, if no such showing is made by the Commission, a finding of unlawful State Aid is not warranted.

Regarding the Starbucks matter, the E.G.C. found that the Commission did not prove a selective advantage was granted by the tax ruling. Even certain methodological deficiencies in the application of the arm’s length principal would not, *per se*, indicate the existence of a selective advantage within the meaning of State Aid law. In contrast, the Fiat decision by the E.G.C. confirmed the Commission’s assertion that Luxembourg granted selective tax advantages by way of tax rulings that confirmed transfer prices that did not comply with market terms. However, the European Court of Justice (“E.C.J.”) has annulled the Commission’s decision.<sup>52</sup> The Court ruled that the Commission failed to determine the correct system of reference for purposes of qualifying the applied transfer prices as selective. Luxembourg’s national tax law should have been subject to a closer assessment of its basic principles; it is not permissible to determine the reference system by merely looking at O.E.C.D. Guidelines which themselves have no binding authority.

### Appeal by Apple

In the case of Apple, the Commission argued that the transfer prices used were negotiated with Irish tax authorities 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.<sup>53</sup> The Commission contended that, by allowing an unsubstantiated transfer pricing plan, Ireland granted a selective benefit to Apple by lowering its total tax burden.<sup>54</sup> In this dispute over a record back tax payment of €13 billion for Apple in Ireland, the E.G.C. annulled the Commission’s decision.<sup>55</sup> The Court explained that the Commission failed to prove that Ireland granted the U.S. technology company a legally impermissible tax advantage.

Beginning in 2013, the Commission has taken action against tax rulings and similar tax arrangements in individual Member States such as Ireland, Luxembourg, and the Netherlands. In the view of the Commission, the rulings granted by the tax authorities in these Member States were advantageous for the companies involved that they constituted unlawful State Aid. The Apple case is by far the most important and prominent case.

<sup>50</sup> *Netherlands and Starbucks and Starbucks Manufacturing Emea v. Commission*, Joined Cases T-760/15 & T-636/16, [2019] ECLI:EU:T:2019:669.

<sup>51</sup> *Luxembourg and Fiat Chrysler Finance Europe v. Commission*, Joined Cases T-759/15 & T-755/15, [2019] ECLI:EU:T:2019:670.

<sup>52</sup> E.C.J., Judgment of November 8, 2022, C-885/19 P and C-898/19 P.

<sup>53</sup> *State Aid to Apple*, C(2016) 5605 Final.

<sup>54</sup> *Id.*

<sup>55</sup> E.G.C., Judgment of July 15, 2020, T-778/16 and T-892/16.

### Amazon, McDonald's, Nike, and Engie

Amazon,<sup>56</sup> McDonald's,<sup>57</sup> Nike<sup>58</sup> and Engie<sup>59</sup> have come under scrutiny by the Commission for allegedly having benefitted from unlawful tax-related State Aid granted by Luxembourg (Amazon, McDonald's, and Engie) and the Netherlands (Nike). Regarding Amazon, the Commission concluded that the benefit unlawfully granted was worth approximately €250 million. Regarding McDonald's, the investigations indicated that the tax ruling in Luxembourg did not provide the company with selective tax treatment. Regarding Nike, the Commission opened an in-depth investigation in 2019 into tax treatment by the Netherlands. The Commission found that royalty payments permitted in a tax ruling were excessive and for that reason constituted unlawful State Aid.

In the Amazon case, the E.C.J. ruled against the Commission. According to the Commission, Amazon artificially inflated the settlement of royalties between various European subsidiaries in order to escape tax payments, which was explicitly approved by the Luxembourg authorities. However, the E.C.J. found that the Commission incorrectly applied the arm's length principle. According to the E.C.J., the arm's length principle can only be applied when it is incorporated into national law.<sup>60</sup> In the Engie case, the E.C.J. determined that the Commission could not substantiate the claim that the tax rulings granted by Luxembourg to companies within the Engie group constituted a selective tax advantage.<sup>61</sup> The E.C.J. therefore overruled the previous judgment of the E.G.C. The E.G.C. had confirmed the existence of a tax advantage in the tax rulings granted by Luxembourg to companies in the Engie group. In the decision, the court stated that preferential tax treatment resulted from the failure to apply a national measure relating to abuse of law.<sup>62</sup> In the Nike case, the E.G.C. stated the lawfulness of the Commission's decision to initiate the formal investigation procedure. Stressing the importance of examining the individual measure, the court considered whether the Commission's assumption of selectivity met the threshold requirements for the formal investigation procedure without, of course, going into detail regarding the selectivity criteria to be applied.<sup>63</sup>

### Belgian Profit Ruling Scheme

Another example is the in-depth investigations opened by the European Commission in February 2015 regarding the Belgian excess profit ruling scheme.<sup>64</sup> Pursuant to Belgium's national tax regulations, multinational companies were allowed to reduce their tax base for alleged "excess profit" on the basis of a binding tax ruling.

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<sup>56</sup> *State Aid to Amazon*, 2015/C 044/02. See also E.C.J., Judgment of December 5, 2023, C-451/21 P and C-454/21 P.

<sup>57</sup> Commission Press Release, IP/18/5831 (Sept. 19, 2018).

<sup>58</sup> Commission Press Release, IP/19/322 (Jan. 10, 2019).

<sup>59</sup> E.C.J., Judgment of December 5, 2023, C-451/21 P and C-454/21 P.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> E.G.C., Judgment of May 12, 2021, T-816/17 and T-318/18.

<sup>63</sup> E.G.C., Judgment of July 14, 2021, T-648/19.

<sup>64</sup> Commission Decision No. 2016/1699 (*State Aid*), 2016 O.J. L 260/61.

Under such tax rulings, the actual recorded profit of a multinational was compared with the hypothetical average profit that a stand-alone company in a comparable situation would have made. The alleged difference in profit was deemed to be excess profit by the Belgian tax authorities, and the multinational's tax base was reduced proportionately. In practice, the actual recorded profit of companies participating in this scheme was often reduced by more than 50%, and in some cases, up to 90%.<sup>65</sup>

The Commission stated that Belgium provided a select number of multinationals substantial tax advantages in violation of E.U. State Aid rules. It ruled that the scheme distorted competition on the merits by putting smaller competitors on an unequal footing.<sup>66</sup> The Commission's decision required Belgium to stop applying the excess profit scheme and to recover the full unpaid tax from at least 35 multinational companies that benefitted from the unlawful scheme (around €700 million).<sup>67</sup> After the E.G.C. initially annulled the Commission's decision, the E.C.J. referred the case back to the E.G.C.<sup>68</sup> In a second decision, the E.G.C. upheld the Commission's decision.<sup>69</sup>

### German Restructuring Relief

In February 2016, the E.G.C. confirmed the European Commission's decision<sup>70</sup> that the so-called restructuring relief clause under German corporate tax law that enabled an ailing company to offset its losses in a given year against profits in future years, despite changes in its shareholder structure, amounts to State Aid.<sup>71</sup>

The clause departed from the general principle in the corporate tax law of Germany that prevented the carryforward of losses for fiscal purposes precisely when there has been a significant change in the shareholding structure of the company concerned. The restructuring relief therefore favored ailing companies over financially-sound competitors that suffer losses in a given year. For those competitors, the tax benefit of a carryforward is not allowed when a significant change occurs in their shareholder structure. The clause therefore distorts competition in the single market.

The German authorities' view was that the clause was merely a new technical feature of the German tax system, and for that reason, could escape qualification as State Aid. This argument convinced neither the Commission nor the E.G.C. However, in line with the opinion<sup>72</sup> of Advocate General Wahl, the E.C.J. ruled that the general right to carry forward losses is the relevant reference framework, so that the

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<sup>65</sup> *Id.*

<sup>66</sup> *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> E.C.J., Judgment of September 16, 2021, C-337/19 P.

<sup>69</sup> E.G.C., Judgment of September 20, 2023, T-131/16 P.

<sup>70</sup> Commission Decision No. 2011/527/E.U. (*Sanierungsklausel*), 2011 O.J. L 235/26.

<sup>71</sup> *SinnLeffers v. Commission*, Case T-620/11, [2016] E.G.C. ECLI:EU:T:2016:59.

<sup>72</sup> Opinion of the Advocate General Wahl, *Dirk Andres (administrator of Heitkamp BauHolding GmbH), previously Heitkamp BauHolding GmbH v. Commission*, Case C-203/16 P, [2017] ECLI:EU:C:2017:1017.

benefit was not selective. The Commission erred when it viewed forfeiture of loss carryforwards in case of a change of control as the framework.<sup>73</sup>

### German Real Estate Transfer Tax

In another decision by the E.C.J., a rule under the German real estate transfer tax law which provided benefits to intragroup transfers of real estate or shares in real estate owning entities<sup>74</sup> (subject to certain strict requirements), was found not to constitute unlawful State Aid. The intragroup relief is justified by the nature and overall structure of the underlying tax system as it helps to avoid double taxation and thus excessive taxation since real estate transfer tax was triggered by the initial acquisition of the real estate by the relevant group company.

### World Duty Free Group and Spain

Another ruling of the E.C.J. relates to a Spanish provision under which goodwill could be deducted when a Spanish-resident corporation acquired a shareholding in a foreign company equal to at least 5%.<sup>75</sup> No tax deduction for goodwill was granted when acquiring a shareholding in a domestic company.

Even though the E.C.J. returned the matter to the E.G.C., the ruling gave clear instruction on how the E.C.J. defines selectivity. A measure is selective if it places one undertaking in a position that is more favorable than that of another undertaking, although both undertakings are in a comparable factual and legal situation.<sup>76</sup> There is no need to identify certain specific features that characterize a group of undertakings that are beneficiaries to the tax advantage.<sup>77</sup>

This decision faces some criticism. According to the E.C.J., it is sufficient, if the measure in question discriminates between companies in comparable situations. It is not necessary for the Commission to determine the advantage for certain undertakings. Commentators have pointed out that this view is not compatible with the wording of Article 107 §1 T.F.E.U.<sup>78</sup>

### German Exemption of Waiver Gains

The increasing relevance of the State Aid rules for individual Member State's tax legislation is further evidenced by Germany's decision to notify the Commission of a new statutory rule providing for an exemption of waiver gains from income tax



<sup>73</sup> *Andres (faillite Heitkamp BauHolding) v. Commission*, Case C-203/16 P, [2018] ECLI:EU:C:2018:505; *Germany v. Commission*, Case C-208/16 P, [2018] ECLI:EU:C:2018:506; *Germany v. Commission*, Case C-209/16 P, [2018] ECLI:EU:C:2018:507; *Lowell Financial Services v. Commission*, Case C-219/16 P, [2018] ECLI:EU:C:2018:508; see also *Strüber/von Donat*, IFSt Nr.531, 2019, p 26(ff).

<sup>74</sup> *A-Brauerei*, Case C-374/17, [2018] ECLI:EU:C:2018:1024; see also *Strüber/von Donat*, IFSt Nr.531, 2019, p 34(ff).

<sup>75</sup> *Commission v. World Duty Free Group*, Joined Cases C-20/15 P & C-21/15 P [2016] E.C.R. I (delivered Dec. 21, 2016).

<sup>76</sup> *Id.*, ¶79.

<sup>77</sup> *Id.*, ¶78.

<sup>78</sup> *Strüber/von Donat*, IFSt Nr.531, 2019, p 24(f).



and trade tax.<sup>79</sup> The Commission responded to the notice by way of an informal and unpublished comfort letter confirming that they do not see any conflict with the State Aid rules.

### Path Forward

The extensive application of the State Aid rules with regard to direct taxation leads to a conflict with the principle of the autonomy of Member States in the field of taxation, and has been met with increasing criticism.<sup>80</sup> The E.G.C. for the first time examined the legality of a State Aid scheme under Article 107(2)(b) T.F.E.U. in the context of the COVID-19 pandemic and affirmed that State Aid provided in order to enable a company to overcome a crisis is not unlawful.<sup>81</sup> The case involved France, which supported airlines with French operating licenses with a payment moratorium during the pandemic. Ryanair, the holder of an Irish license, saw this as discrimination and filed a lawsuit. The E.G.C. ruled that France's aid measures to support airlines was lawful. In the decision, the E.G.C. pointed to a Commission ruling that a payment moratorium was compatible with the internal market. The moratorium provided that the payment of the monthly civil aviation tax and the solidarity levy on airline tickets from March to December 2020 can be deferred until 2021. According to the Commission, this constituted aid to make good the damage caused by natural disasters or exceptional occurrences (Article 107(2)(b) T.F.E.U.). The E.G.C. agreed with the Commission's view. This was the first time the E.G.C. examined the legality of a State Aid scheme under Article 107(2)(b) T.F.E.U. in the context of the COVID-19 pandemic.

The E.C.J. ruled that, with the exception of areas of tax law that have been harmonized, the determination of the basic characteristics of a tax provision under the law of a Member State is left to the discretion of that Member State, provided that the exercise of discretion is in accordance with E.U. law.<sup>82</sup> Moreover, E.U. law in the area of State Aid does not prevent Member States from adopting progressive tax rates reflecting the capacity of wealthier taxpayers to pay tax at higher rates than others having lower incomes. Similarly, Member States are not prohibited from using progressive taxation in the context of corporate taxes and taxes on persons with legal identity.

In addition, E.U. law does not preclude progressive taxation linked to turnover. One case involved a retail sales tax in Poland. It was unsuccessfully challenged by the Commission. The turnover tax was found to be a direct tax and the Commission was not able to demonstrate that the progressive nature of the tax rates was designed to circumvent the rules attacking unlawful State Aid.

On March 3, 2021, the E.C.J. ruled with regard to Article 107(1) of the T.F.E.U. that, in accordance with settled case law, levies do not fall within the scope of the provisions of the T.F.E.U. on State Aid unless they constitute the method of financing an

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<sup>79</sup> Section 3a *Einkommensteuergesetz – EstG* [hereinafter the “Income Tax Act”] and Section 3a *Gewerbsteuergesetz – GewStG* [hereinafter the “Trade Tax Act”].

<sup>80</sup> Opinion of Advocate General *Saugmandsgaard ØE*, delivered on September 19, 2018, Case C-374/17, ECLI:EU:C:2018:741; *Strüber/von Donat*, IFSt Nr.531, 2019, p 67(ff).

<sup>81</sup> E.G.C. Judgment of February 17, 2021, T-259/20.

<sup>82</sup> E.C.J., Judgment of March 16, 2021, C-562/19 P.

*“In another decision, the E.C.J. found that a Spanish law that lowered the taxes for Spanish football clubs amounted to unlawful State Aid.”*

aid measure, and as a result, form an integral part of that measure.<sup>83</sup> In the facts of the case presented to the E.C.J., there was no indication that the revenue from the levy of the I.V.P.E.E., a direct tax on the value of the production of electric energy supplied to the Spanish electricity system, constituted a financing method amounting to unlawful State Aid. Consequently, the I.V.P.E.E. did not fall within the scope of the provisions of the T.F.E.U. on State Aid.

In another decision, the E.C.J. found that a Spanish law that lowered the taxes for Spanish football clubs amounted to unlawful State Aid.<sup>84</sup> Spanish law has long allowed specific Spanish football clubs – F.C. Barcelona, Real Madrid, Athletic Bilbao, and Atlético Osasuna – to pay lower taxes than most of its competitors. The basis of the lower tax was their characterization as non-profit organizations. The Court confirmed the Commission’s view that the tax advantages provided by the law constituted unlawful State Aid, irrespective of other tax issues that also played a role. Although an aid scheme must always be considered as a whole, it is not necessary to determine the exact advantage that the beneficiary ultimately derives in order to establish the existence of aid. The quantification of the amount of the unlawful State Aid is deferred until the time of a recovery action by the Member State. The decisive factor, according to the E.C.J., was that the aid scheme was applied to favor the four football clubs but not their competitors, all of whom operated as stock corporations. Consequently, the advantage violated Article 107(1) T.F.E.U.

Another Spanish tax regime that was found to constitute unlawful State Aid related to certain finance lease agreements concluded by shipyards.<sup>85</sup> The E.G.C. found that the use of the tax scheme at issue was granted by the tax administration based on vague criteria for which no framework apparently existed. Specifically, the tax administration could determine the date of commencement of depreciation on the basis of criteria that were defined in such a way as to give the tax administration a significant margin of discretion. As a result, companies that received rulings were in a better position than other taxpayers with comparable facts. Consequently, the conditions relating to the risk of distortion of competition and its effect on trade between Member States were met. The E.C.J. upheld the E.G.C.’s decision that the Spanish tax regime constituted unlawful State Aid, particularly that the State Aid was selective.<sup>86</sup>

On April 17, 2024, the E.G.C. affirmed the Commission’s decision<sup>87</sup> that a law under which only credit institutions that exceed a certain profit threshold are subject to tax is in accordance with the reference system of Swedish tax law and therefore does not constitute unlawful State Aid.<sup>88</sup> One of the reasons provided by the E.G.C. was that, according to the explanatory memorandum to the Swedish law, this system serves to offset indirect costs that would be incurred in the event of a crisis, particularly by credit institutions that exceed the profit threshold.

<sup>83</sup> E.C.J., Judgment of March 3, 2021, C-220/19.

<sup>84</sup> E.C.J., Judgment of March 4, 2021 - C-362/19 P.

<sup>85</sup> E.G.C., Judgment of September 23, 2020, T-515/13 RENV and T-719/13 RENV.

<sup>86</sup> E.C.J., Judgment of February 2, 2023, C-649/20 P and C-662/20 P.

<sup>87</sup> Commission Decision 2021/8637/E.U.

<sup>88</sup> E.G.C., Judgment of April 17, 2024, T-112/22.

### Application of State Aid Rules to Third Countries

On December 23, 2022, the European Union adopted Regulation 2022/2560 of the European Parliament and of the Council on foreign subsidies distorting the internal market (the Foreign Subsidies Regulation or “F.S.R.”).<sup>89</sup> The purpose of the F.S.R. is to give the Commission the power to effectively deal with distortions in the internal market caused by foreign subsidies to ensure a level playing field. This includes a requirement for companies to notify the Commission of both M&A transactions and public tenders if the parties involved have received foreign financial contributions as well as ex officio investigations. According to Article 3 of the F.S.R., a foreign subsidy shall be deemed to exist where a third country provides, directly or indirectly, a financial contribution which confers a benefit on an undertaking engaging in an economic activity in the internal market and which is limited, in law or in fact, to one or more undertakings or industries. For the purposes of the regulations, a financial contribution is defined as any of the following items, among other explicitly named tax advantages:

- The transfer of funds or liabilities, such as capital injections, grants, loans, loan guarantees, fiscal incentives, compensation for financial burdens imposed by public authorities, debt forgiveness, debt to equity swaps or re-scheduling
- The foregoing of revenue that is otherwise due, such as tax exemptions or the granting of special or exclusive rights without adequate remuneration
- The provision of goods or services or the purchase of goods or services

## TRANSPARENCY MEASURES

The increasing relevance of State Aid proceedings in the area of direct taxes illustrates 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 combatting base erosion and profit shifting. 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, Council Directive 2011/16/E.U. (the “Administrative Cooperation Directive”), as amended,<sup>90</sup> lays down the provisions for the cooperation of Member States in the exchange of information that may be relevant to the administration of domestic tax law. On June 2, 2020, the Council approved the conclusions on the Directive.<sup>91</sup>

<sup>89</sup> Council Regulation 2022/2560/E.C. on foreign subsidies distorting the internal market, 2022 O. J. L 330/1.

<sup>90</sup> Council Directive 2011/16/E.U. on Administrative Cooperation in the Field of Taxation, 2011 O.J. L 64/1 [hereinafter the “Administrative Cooperation Directive”], amended by Council Directive 2014/107/E.U., 2014 O.J. L 359/1; Council Directive 2015/2376/E.U., 2015 O.J. L 332/1; Council Directive 2016/881/E.U., 2016 O.J. L 146/8; Council Directive 2016/2258/E.U., 2016 O.J. L 342/1; Council Directive 2018/822/E.U., 2018 O.J. L 139/1; Council Directive 2020/876/E.U., 2020 O.J. L 204/46 and Council Directive 2021/514/E.U., 2021 O.J. L 104/1.

<sup>91</sup> Council of the European Union, *Council conclusions on the future evolution of administrative cooperation in the field of taxation in the EU*, June 2, 2020, 8482/20.

The conclusions stress that efforts to improve administrative cooperation to fight tax fraud and tax evasion are particularly relevant in the context of the need for recovery from the crisis caused by the COVID-19 pandemic.<sup>92</sup> Furthermore, it notes that the Directive does not provide for a procedure relating to data protection in the event of a data breach and calls on the Commission to suggest appropriate substantive amendments to the Directive or other relevant E.U. legislation. Meanwhile, it is appropriate to continue work on rapidly finding an administrative solution with the objective of improving the security of data exchanged between the authorities involved in tax information exchange and acting as data controllers.<sup>93</sup> The Member States should also establish a common standard at E.U. level for the reporting and tax information exchange mechanisms of income (revenue) generated through digital platforms.<sup>94</sup>

Pursuant to this Directive, Member States are obligated to share information that is foreseeably relevant to the administration of all taxes (except for V.A.T. and customs duties, excise duties, and compulsory social contributions) of another Member State in five different situations.<sup>95</sup>

### *Mandatory Automatic Exchange of Information*

The tax authorities of a Member State must communicate any available information regarding taxable periods beginning on or after January 1, 2014, concerning residents in another Member State relating to income from

- employment;
- director's fees;
- life insurance;
- pensions;
- the ownership of and income from immovable property;
- royalties;<sup>96</sup> and
- from January 1, 2026, non-custodial dividend income other than income from dividends exempt from corporate income tax.<sup>97</sup>

Council Directive 2014/107/E.U. of December 9, 2014, 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, the account balance as of the end of a calendar year, and the total gross amount of interest,

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<sup>92</sup> *Id.*, No. 5.

<sup>93</sup> *Id.*, No. 14.

<sup>94</sup> *Id.*, No. 8.

<sup>95</sup> Administrative Cooperation Directive, art. 2, §2.

<sup>96</sup> As of January 1, 2023. Administrative Cooperation Directive, art. 8, §1.

<sup>97</sup> Administrative Cooperation Directive, art. 8, §1. as amended by Council Directive 2023/2226/E.U.

dividends, and gains from the disposal of financial assets credited to the concerned account.<sup>98</sup>

Since its amendment on December 8, 2015, the Administrative Cooperation Directive also provides for the automatic exchange of information regarding, *inter alia*, the following types of cross-border tax rulings and advance pricing arrangements, effective as of January 1, 2017:

- Unilateral advance pricing arrangements and/or decisions
- Bilateral or multilateral advance pricing arrangements and decisions
- Arrangements or decisions determining the existence or absence of a permanent establishment
- Arrangements or decisions determining the existence or absence of facts with a potential impact on the tax base of a permanent establishment
- Arrangements or decisions determining the tax status of a hybrid entity in one Member State which relates to a resident of another jurisdiction
- Arrangements or decisions on the assessment basis for the depreciation of an asset in one Member State that is acquired from a group company in another jurisdiction<sup>99</sup>

The Commission will develop a secure central directory to store the information exchanged. This directory will be accessible to all Member States and, to the Commission for purposes of monitoring the correct implementation of the directive.

### Spontaneous Exchange of Information

Member States must also 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 an artificial transfer of 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.<sup>100</sup>



<sup>98</sup> *Id.*, art. 8, §3(a), as amended by Council Directive 2014/107/E.U.

<sup>99</sup> *Id.*, art. 8a, as amended by Council Directive 2015/2376/E.U.

<sup>100</sup> *Id.*, art. 9, §1.

### Exchange of Information on Request

Member States must exchange information on taxes that may be relevant to another Member State upon request of the other Member State.<sup>101</sup>

### Country-by-Country Reporting

The amendment of the Administrative Cooperation Directive by Council Directive 2016/881/E.U. of May 25, 2016<sup>102</sup> introduced rules requiring multinational companies to report certain tax-related information and the exchange of that information between Member States. Under the new rules, multinational groups of companies located in the E.U. or with operations in the E.U. having a total consolidated revenue equal to or greater than €750 million will be obligated to file a Country-by-Country (“C-b-C”) Report. The competent national authority that receives the C-b-C Report must communicate the report by automatic exchange to any other Member State in which one or more constituent entities of the multinational group are either resident for tax purposes or are subject to tax with respect to business carried out through a permanent establishment. The C-b-C Report is filed in the Member State in which the ultimate parent entity of the group or any other reporting entity is a resident for tax purposes. The report must include the following information for every tax jurisdiction in which the group is active:

- Amount of revenue
- Profit (loss) before income tax
- Income tax paid (on cash basis)
- Income tax accrued (current year)
- Stated capital
- Accumulated earnings
- Number of employees
- Tangible assets other than cash and cash equivalents

In general, C-b-C Reports must be provided within 15 months of the last day of the fiscal year of the reporting multinational group. The rule is somewhat different for the first C-b-C Reports. The first reports must relate to the reporting group’s fiscal year commencing on or after January 1, 2016, and must be submitted within 18 months of the last day of that fiscal year.<sup>103</sup>

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<sup>101</sup> *Id.*, art. 5.

<sup>102</sup> The directive is the first element of a January 2016 package of Commission proposals to strengthen rules against corporate tax avoidance. The directive builds on the 2015 O.E.C.D. recommendations to address base erosion and profit shifting and will implement O.E.C.D. B.E.P.S. Action 13, on country-by-country reporting by multinationals.

<sup>103</sup> *Id.*, art. 1, ¶2.

Germany implemented the provisions relating to C-b-C Reporting and the automatic exchange of cross-border tax rulings and advance pricing arrangements into law on December 20, 2016.<sup>104</sup>

### ***Mandatory Exchange of Information of Tax Cross-Border Arrangement***

On May 25, 2018, the Ecofin Council of Economic and Finance Ministers adopted the Council Directive 2018/822/E.U., which amended Council Directive 2011/16/E.U. and entered into force on June 25, 2018. This directive addresses mandatory automatic exchange of information in the field of taxation of reportable cross-border models as a tool to prevent aggressive cross-border tax arrangements. Under the new rules, an external adviser (“intermediary”) who designs, markets, organizes, or makes a model available for use or controls the implementation of the model is required to report any tax arrangement that generates an abusive tax benefit identified in Annex IV of Council Directive No. 2018/822/E.U. (*Hallmarks*).

A reportable cross-border tax arrangement must be identified by hallmarks, at least one of which must be present. Some of these hallmarks may only be taken into account where they fulfil the “main benefit test.” That test will be satisfied if it can be established that the expectation of a tax advantage is the main benefit or one of the main benefits, having regard to all relevant facts and circumstances, for entering into an arrangement.<sup>105</sup>

Hallmarks linked to the main benefit test include the following:

- Performance-based fees<sup>106</sup>
- Standardized structures (that are available to more than one relevant taxpayer without a need to be substantially customized for implementation)<sup>107</sup>
- Inappropriate legal steps to exploit losses<sup>108</sup>
- Conversion of income into non-taxed or low-taxed income<sup>109</sup>
- Circular transactions through intermediate companies without economic activity<sup>110</sup>

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<sup>104</sup> *Gesetz zur Umsetzung der Änderungen der E.U.-Amtshilferichtlinie und von weiteren Maßnahmen gegen Gewinnverkürzungen und -verlagerungen (B.E.P.S.-Umsetzungsgesetz) v. 23.12.2016, BGBl. I 2016, p. 3000* [“Law for the Implementation of the Amendments to the Administrative Cooperation Directive and of Further Measures Against Base Erosion and Profit Shifting”].

<sup>105</sup> Administrative Cooperation Directive, Annex IV, Part I.

<sup>106</sup> *Id.*, Annex IV, Part II.A.2.

<sup>107</sup> *Id.*, Annex IV, Part II.A.3.

<sup>108</sup> *Id.*, Annex IV, Part II.B.1.

<sup>109</sup> *Id.*, Annex IV, Part II.B.2.

<sup>110</sup> *Id.*, Annex IV, Part II.B.3.

- Exploitation of territories with no corporate tax or a rate close to zero<sup>111</sup>
- Cross-border payments between two or more associated enterprises in tax jurisdictions with tax exemptions or preferential tax regimes<sup>112</sup>

Other hallmarks exist even if the expectation of a tax advantage is not among the main benefits for entering the transaction. Where such other hallmarks exist, reporting is required in all circumstances. These hallmarks include the following:

- Payments between two or more associated enterprises where the recipient is not resident for tax purposes in any tax jurisdiction<sup>113</sup> or is resident in an E.U. blacklisted tax jurisdictions<sup>114</sup>
- Transfers of assets between two tax jurisdictions with substantially different valuations<sup>115</sup>
- Specific transfer pricing structures (e.g., arrangement which involves the use of safe-harbor-rules or arrangement involving the transfer of hard-to-value intangibles)<sup>116</sup>

The report must be provided by the intermediary, or if the intermediary benefits from a professional privilege, by the user within 30 days of the first act of implementation of the tax model or within 30 days after the tax model has been made available to the users. The competent national authority that receives the tax model reporting must communicate the report by automatic exchange to any other Member State. The report must include the following information for every tax jurisdiction in which the group is active:

- Personal data of the intermediary (user)
- Summary of the tax model
- Characteristics constituting the reporting
- Date of implementing tax model
- Provisions on which the tax model is based

In general, the provisions apply from July 1, 2020 in all cases where the first act of a reportable cross-border arrangement was implemented after June 24, 2018. If the first act was implemented after June 24, 2018 but before July 1, 2020, the notification must be submitted by August 31, 2020. However, for those arrangements being implemented before July 1, 2020, the reporting is not afflicted with penalties.

Violations of the notification obligation are to be punished with a fine. The amount of the fine varies considerably between the E.U. Member States. Whereas, in some Member States, e.g. Latvia or France, the fine is less than €10,000, in other

***“In general, the provisions apply from July 1, 2020 in all cases where the first act of a reportable cross-border arrangement was implemented after June 24, 2018.”***

<sup>111</sup> *Id.*, Annex IV, Part II.C.1.(b).(i).

<sup>112</sup> *Id.*, Annex IV, Part II.C.1.(c) and (d).

<sup>113</sup> *Id.*, Annex IV, Part II.C.1.(a).

<sup>114</sup> *Id.*, Annex IV, Part II.C.1.(b).(ii).

<sup>115</sup> *Id.*, Annex IV, Part II.C.4.

<sup>116</sup> *Id.*, Annex IV, Part II.E.



countries, the penalties are much higher. In the Netherlands, the fine can be up to €870,000 and in Poland even up to approximately €5 million. In Germany, the fine amounts up to €25,000.

### C-b-C Reporting Requirements for Platform Operators

The amendment of the Administrative Cooperation Directive by Council Directive 2021/514/E.U. of March 22, 2021 (“D.A.C. 7”) introduced reporting requirements for platform operators regarding transactions with registered vendors under certain conditions.<sup>117</sup>

### Information Exchange and Reporting Requirements Regarding Crypto Assets

As of January 1, 2026, Directive 2023/2226/E.U. (“D.A.C. 8”) amending Council Directive 2011/16/E.U. will take effect.

This directive primarily concerns the reporting and automatic exchange of information on income from transactions in crypto-assets and information on advance rulings for the wealthiest individuals.

### Framework for Business Taxation (“B.E.F.I.T.”)

On September 12, 2023, the European Commission adopted a proposal for a Council Directive on Business in Europe: Framework for Income Taxation (“B.E.F.I.T.”).<sup>118</sup> The proposal establishes a new, common set of rules for determining the tax base of groups of companies in the E.U. The proposal stipulates that groups operating in the E.U. with a combined annual turnover of at least €750 million will be required to submit a single tax return to the tax administration of a Member State that covers the tax bases of all group members. Smaller groups will be able to opt in as long as they prepare consolidated financial statements.

### Public Tax Transparency Rules for Multinationals

Pursuant to Directive 2021/2101/E.U. amending Directive 2013/34/E.U., the ultimate parent undertaking is obligated to publish an income tax information report for the previous financial year if the group has had a consolidated revenue in excess of €750 million for each of the last two consecutive financial years, as reflected on their consolidated financial statements. In the event that the parent company has its registered office abroad, a branch in a Member State may be required to publish the report.<sup>119</sup> The report must be published on the undertaking’s website or, in certain instances, on the website of a subsidiary or affiliated undertaking.<sup>120</sup> If a foreign parent company has a branch in a Member State, the branch or the undertaking that opened the branch (or an affiliated undertaking) must publish the report on its website.<sup>121</sup> The income tax information report contains data on all activities of the ultimate parent company and the affiliated companies.<sup>122</sup> For example, the income tax information report must contain a brief description of the nature of their activities,

<sup>117</sup> *Id.*, art. 8ac, as amended by Council Directive 2021/514/E.U.

<sup>118</sup> COM (2023) 532 Final.

<sup>119</sup> Council Directive 2021/2101/E.U., art. 48b, §5.

<sup>120</sup> *Id.*, art. 48d, §2.

<sup>121</sup> *Ibid.*

<sup>122</sup> Council Directive 2021/2101/E.U., art. 48c, §1.



the number of employees on a full-time or equivalent basis, the amount of profit or loss before income tax, and the amount of income tax accrued during the relevant financial year.<sup>123</sup> The report on income tax information must be published within 12 months of the balance sheet date of the financial year for which the report is drawn up.<sup>124</sup> Importantly, the report must be accessible on the website for a minimum of five consecutive years.<sup>125</sup> The Member States were required to implement the laws, regulations, and administrative provisions necessary to comply with the Directive by June 22, 2023.<sup>126</sup>

### **Mandatory use of International Accounting Standards**

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

With respect to listed companies, Council Regulation 1606/2002/E.C., as amended,<sup>127</sup> grants the European Commission the authority to adopt the International Financial Reporting Standards, the International Accounting Standards, and the related Interpretations (“S.I.C./I.F.R.I.C.-Interpretations”) issued by the International Accounting Standards Board (“I.A.S.B.”).<sup>128</sup> On this legal basis, the Commission adopted a set of international financial reporting standards by issuing Commission Regulation 2023/1803/E.U.<sup>129</sup> 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.<sup>130</sup> Therefore, the I.A.S. Regulation is amended on a continuing basis.

Besides the use of international financial reporting standards, further reporting requirements for listed companies arise from the Transparency Directive<sup>131</sup> and the Prospectus Regulation.<sup>132</sup>

<sup>123</sup> For further details see Council Directive 2021/2101/E.U., art. 48c, §2.

<sup>124</sup> *Id.*, art. 48d, §1.

<sup>125</sup> *Id.*, art. 48d, §4.

<sup>126</sup> *Id.*, art. 2, §1.

<sup>127</sup> Council Regulation 1606/2002/E.C. on the Application of International Accounting Standards, 2002 O.J. L 243/1 [hereinafter “Application of I.A.S.”], as amended by Council Regulation 297/2008/E.C. on the Implementing Powers Conferred on the European Commission, 2008 O.J. L 97/62.

<sup>128</sup> Application of I.A.S., art. 2 and art. 3, §1.

<sup>129</sup> Commission Regulation 2023/1803/E.U. Adopting Certain International Accounting Standards, 2023 O.J. L237/1.

<sup>130</sup> For further details regarding the endorsement process, see Application of I.A.S., art. 6, and Council Regulation No. 182/2011/E.U., 2011 O.J. L 55/13, art. 5.

<sup>131</sup> Council Directive 2008/22/E.C. on the Harmonization of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market, 2008 O.J. L 76/50 [hereinafter the “Transparency Directive”].

<sup>132</sup> Council Regulation 2017/1129/E.C. on the Prospectus to be Published when Securities are Offered to the Public or Admitted to Trading on a Regulated Market, and Repealing Directive 2003/71/E.C. Text with EEA Relevance, 2017 O.J. L 168/1264 [hereinafter the “Prospectus Regulation”].

- Pursuant to the Transparency Directive, issuers are required to inform the public market periodically about their financial statements and their management report.<sup>133</sup>
- Pursuant to the Transparency Directive, shareholders of listed companies are subject to reporting obligations if their voting rights exceed or fall below defined thresholds following an acquisition or a disposal of shares.<sup>134</sup>
- Pursuant to the Prospectus Regulation, which is directly applicable in the domestic legislation of all Member States, 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.<sup>135</sup>

Companies in the legal form of limited liability companies or in the legal form of partnerships, whose partners have limited liability, fall under the scope of the Accounting Directive.<sup>136</sup> The Accounting Directive requires these entities to present their annual financial reports in compliance with the general principles set forth in the directive. These provisions broadly cover an entity's balance sheets, profit and loss accounts, notes on financial statements, and management reports. In addition, the Accounting Directive requires the publication and disclosure of the required information and the audit of financial statements. With respect to small- and medium-sized enterprises, the Member States may apply optional exemptions to the regulatory requirements of the Accounting Directive to avoid excessive demands for those undertakings. The laws and provisions necessary to comply with the Accounting Directive must be effective as of July 20, 2015.<sup>137</sup>

In addition, another directive requires large groups to report non-financial and diversity information. The affected companies will be obligated to publish information providing an understanding of the undertaking's development, performance, and position, the impact of its activity on environmental, social, and employee matters, and its respect for human rights and handling of anti-corruption and anti-bribery matters. The Member States were required to transfer these provisions into domestic law by December 6, 2016.<sup>138</sup>

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<sup>133</sup> Transparency Directive, Chapter II.

<sup>134</sup> *Id.*, Chapter III.

<sup>135</sup> Prospectus Regulation, art. 3.

<sup>136</sup> Council Directive 2013/34/E.U. on the Annual Financial Statements, Consolidated Financial Statements, and Related Reports of Certain Types of Undertakings, 2013 O.J. L 182/19 [hereinafter the "Accounting Directive"].

<sup>137</sup> *Id.*, art. 53, §1.

<sup>138</sup> See art. 4, §1 of Council Directive 2014/95/E.U. on the Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups, 2014 O.J. L 330/1, which amends the Accounting Directive.

# ANTI-ABUSE AND TAX AVOIDANCE MEASURES

## **General Anti-Abuse Doctrine Under E.U. Law**

In two decisions,<sup>139</sup> the E.C.J. dealt with situations in which the abusive use of the Parent-Subsidiary Directive and the Interest and Royalties Directive was at issue.

The joined cases regarding the abusive use of the Interest and Royalties Directive<sup>140</sup> had essentially the same, or a similar, fact pattern. Private equity funds (“A”) based outside the E.U. held shares in an E.U.-based (Danish) group of companies through intermediary holding companies that were based in another E.U. Member State (Luxemburg or Sweden). The E.U.-based intermediary holding companies granted interest-bearing loans to the Danish companies. The Danish debtor companies requested an exemption from Danish withholding tax for interest payments made to the E.U. intermediary holding companies based on the place of residence of the intermediary holding companies in a Member State of the E.U. The exemption request was based on the Interest and Royalties Directive, whose benefits are available solely to E.U.-based companies. The Danish tax authorities denied the exemption on the grounds that the intermediate holding companies were not the beneficial owners of the interest income, but rather their non-E.U. owners, and that the insertion of the intermediate holding companies with little substance constituted an abusive practice designed to artificially create the conditions for obtaining a tax benefit under E.U. law.

This back-to-back lending arrangement was designed to achieve a reduction in withholding taxes under the Interest and Royalties Directive. The companies ultimately receiving the interest payments did not qualify for the elimination of withholding tax imposed by the E.U. Member State that was the place of residence of the ultimate borrower (Denmark). Hence, a two-legged arrangement was entered, in which the first leg of the back-to-back arrangement was the loan to the intermediary entities and the second leg was the loan to the Danish ultimate borrowers.

In its response to the various questions submitted by the Danish tax court in a request for a preliminary ruling on the interpretation of E.U. law, the E.C.J. held that the exemption from withholding tax on interest payments is restricted to the beneficial owner of the interest. The beneficial owner is the entity that actually benefits economically from the interest payment. To be the beneficial owner, the second lender in a two-legged transaction must have the power to freely determine the use to which the interest payment is put. The O.E.C.D. Commentaries to the Model Convention can be used to provide guidance on beneficial ownership for purposes of applying the beneficial ownership standard.

Moreover, applying general principles of E.U. law, the Interest and Royalties Directive cannot be relied upon as support for abusive and fraudulent ends. National courts and authorities are to refuse a taxpayer a benefit granted under E.U. law even if there are no domestic law or agreement-based provisions providing for such

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<sup>139</sup> *N Luxembourg 1 v. Skatteministeriet*, Joined Cases C-115, C-118, C-119 & C-299/16, [2019] ECLI:EU:C:2019:134; *Skatteministeriet v. T Danmark und Y Denmark Aps*, Joined Cases C-116/16 & C-117/16, [2019] ECLI:EU:C:2019:135.

<sup>140</sup> Council Directive 2003/49/E.C. on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, 2003 O.J. L 157/49.

a refusal. Proof of an abusive practice requires a combination of (i) objective circumstances in which the purpose of those rules has not been achieved (despite their formal observance) and (ii) a subjective element consisting in the intention to obtain an advantage from the E.U. rules by artificially creating a fact pattern that suggests the conditions are met for obtaining the benefit. The presence of certain indications may demonstrate that an abuse of law exists. These include (i) the existence of a conduit company that is without economic justification and (ii) the purely formal nature of the structure of the group of companies, the financial arrangements, and the loans.

As a final point, the E.C.J. looked at one of the structures in which A was a collective investment entity based in Luxembourg that benefitted from favorable tax treatment as a *Société d'Investissement en Capital à Risque* or S.I.C.A.R. A S.I.C.A.R. is a company with share capital and in principle is subject to Luxembourg corporate income tax and municipal business tax at ordinary rates. However, dividends and interest on risk capital derived by a S.I.C.A.R. is specifically exempt from tax in its hands. Similar tax rules apply to Reserved Alternative Investment Funds known as R.A.I.F.'s. The E.C.J. concluded that a S.I.C.A.R. cannot benefit from the Interest and Royalties Directive with regard to interest income that is exempt from tax in its hands.

The E.C.J. affirmed this principle in several cases regarding the Parent-Subsidiary Directive.<sup>141</sup> These cases concerned holding companies of E.U. Member States receiving dividends from their Danish subsidiaries and distributing them through other intermediary companies to investment funds and their shareholders. In these cases, the granting of benefits of the Parent-Subsidiary Directive to the holding companies was in issue. The E.C.J. ruled that the Parent-Subsidiary Directive cannot be applied in an improper or abusive fact pattern. A Member State is obligated to apply anti-abuse rules of its tax conventions and the O.E.C.D. Commentary to prevent abuse where national law contains no anti-abuse provision applicable to a particular transaction.

However, in a decision dealing with the German anti-treaty shopping legislation and directive rules regarding relief from dividend withholding taxes, the E.C.J.<sup>142</sup> ruled that a domestic anti-abuse provision<sup>143</sup> infringes upon the anti-abuse provision found in Article 2(1) of the E.U. Parent-Subsidiary Directive and the fundamental freedoms of E.U. law. The German law provided that an irrefutable presumption of abuse exists when certain facts are present. Consequently, no obligation is imposed on the tax authorities to provide even *prima facie* evidence of fraud or abuse. Consequently, it was not possible for the applicant to refute the allegation of abuse by factual evidence to the contrary. In the view of the E.C.J., in order to determine whether abuse is present, the structure must be examined on a case-by-case basis, with an overall assessment based on factors such as the organizational, economic, or other substantial features of the group of companies to which the parent company belongs and the structures and strategies of that group.



<sup>141</sup> *Id.*

<sup>142</sup> *Deister Holding AG and Juhler Holding A/S*, Joined Cases C-504/16 & C-613/16, ECLI:EU:C:2017:1009.

<sup>143</sup> Section 50d(3) of the German Income Tax Act in the version of the Annual Tax Act 2007.

*“The Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments Member States of entities resident for tax purposes in a third country.”*

## **Legislative Measures**

In January 2016, the European Commission adopted an Anti-Tax Avoidance Package as part of its agenda for fair corporate taxation in Europe. The package contains concrete measures to “prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the E.U.”<sup>144</sup> One key element of this package is the Anti-Tax Avoidance Directive (“A.T.A.D. 1”). It introduces five legally binding anti-abuse measures that all Member States should apply against common forms of aggressive tax planning until December 31, 2018.<sup>145</sup> Its scope was expanded by A.T.A.D. 2 with regard to Hybrid Mismatches with Third Countries. A.T.A.D. 2 had to be implemented by the Member States until December 31, 2019.

The Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments Member States of entities resident for tax purposes in a third country.<sup>146</sup>

### **General Interest Limitation Rule**

Under the general interest limitation rule, borrowing costs will be deducted to the extent that the taxpayer receives interest or other taxable revenues from financial assets. The deduction of any exceeding borrowing costs will be limited to an amount of 30% of the taxpayer’s earnings before interest, taxes, depreciation, and amortization or €3 million, whichever is higher.<sup>147</sup> The limitation applies without distinction as to the origin of the debt (e.g., it is irrelevant whether the interest is related to intragroup, third-party, E.U., or third-country debt, or whether the lender is effectively taxed on such interest).

Member States have the option to introduce an override if a taxpayer can demonstrate that its ratio of equity to total assets is no more than two percentage points lower than the equivalent group ratio. An additional exception is allowed in cases where excessive borrowing costs are incurred on third-party loans used to fund certain public infrastructure projects. Borrowing costs that cannot be deducted in the current tax year can be carried forward into subsequent tax years without limitation, or can be carried back for three years. Excess interest capacity in any year can be carried forward for five years. Member States can postpone the implementation of the interest expense limitation rule, provided a national rule is in place preventing base erosion and profit shifting that provides a comparable result. The deferred implementation date cannot be later than January 1, 2024, and may be advanced

<sup>144</sup> The key elements of the Anti-Tax Avoidance Package are (i) the Chapeau Communication, (ii) the Anti-Tax Avoidance Directive, (iii) the Administrative Cooperation Directive, (iv) the Recommendation on Tax Treaties, (v) the Communication on an External Strategy for Effective Taxation, and (vi) the Study on Aggressive Tax Planning; “[Anti-Tax Avoidance Package](#).” European Commission Taxation and Customs Union. January 2016, c.f., Commission Communication to the European Parliament and the Council on the Anti-Tax Avoidance Package, COM (2016) 23 Final (Jan. 2016).

<sup>145</sup> Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1 [A.T.A.D. I], amended by Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1 [hereinafter “A.T.A.D. II”].

<sup>146</sup> *Id.*, Article 1 §2.

<sup>147</sup> This provision on the interest limitation rule is similar to the current German interest limitation rule.

in the event of an earlier implementation date in the comparable O.E.C.D. provision under the B.E.P.S. Action Plan.

### Exit Taxation

The provision on exit taxation obliges Member States to apply an exit tax when a taxpayer relocates its assets or tax residence. Examples of this include a taxpayer that falls into any of the following fact patterns:

- It transfers assets from its head office to its permanent establishment in another Member State or in a third country.
- It transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country.
- It transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State.
- It transfers its permanent establishment out of a Member State.

A taxpayer may pay these exit taxes in installments over at least five years for transfers within the E.U. or the E.E.A.<sup>148</sup> Regarding a transfer involving an E.E.A. state, that state must have concluded an agreement on mutual assistance for the recovery of claims that complies with Council Directive 2010/24/E.U.<sup>149</sup>

### General Anti-Abuse Rule

Under the general anti-abuse rule (“G.A.A.R.”), arrangements that are not put into place for valid commercial reasons reflecting economic reality, but are instead put into place for the main purpose (or one of the main purposes) of obtaining a tax advantage that defeats the object or purpose of an otherwise applicable tax provision will be ignored for the purposes of calculating the corporate tax liability. The tax liability will be calculated based on the definition of economic substance in accordance with relevant national law. G.A.A.R. is applicable to domestic as well as cross-border transactions.

### Controlled Foreign Corporation Rules

The controlled foreign company (“C.F.C.”) rules re-attribute the income of a low-taxed C.F.C. to its parent company. This is achieved by adding the undistributed income of an entity to the tax base of a taxpayer in the following cases:

- The taxpayer (together with its associated enterprises) holds (directly or indirectly) more than 50% of the voting rights or capital, or is entitled to receive more than 50% of the profits.
- Under the general regime in the country of the entity, profits are subject to an effective corporate tax rate lower than 50% of the effective tax rate that would

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<sup>148</sup> A.T.A.D., art. 5.

<sup>149</sup> Council Directive 2010/24/E.U. Concerning Mutual Assistance for the Recovery of Claims Relating to Taxes, Duties, and Other Measures, 2010 O.J. L 84/1.

have been charged under the applicable corporate tax system in the Member State of the taxpayer.

- More than one-third of the income of the entity comes from
  - interest or any other income generated by financial assets;
  - royalties or any other income generated from intellectual property or tradable permits;
  - dividends and income from the disposal of shares;
  - financial leasing;
  - immovable property, unless the Member State of the taxpayer would not have been entitled to tax the income under an agreement concluded with a third country;
  - insurance, banking, and other financial activities; or
  - services rendered to the taxpayer or its associated enterprises.
- The entity is not a company whose principal class of shares is regularly traded on one or more recognized stock exchanges.

Undistributed income of a C.F.C. is included in a taxpayer's home country income. According to the E.U. Directive, Member States are allowed to adopt one of two approaches for computing the inclusion:

- The tainted undistributed income listed above is fully included in a shareholder's income, subject to an exception for the undistributed income of a C.F.C. that carries on a substantive economic activity supported by staff, equipment, assets, and premises. Members exclude this active business exception if the C.F.C. is not a resident of an E.U. Member State or an E.E.A. State.
- All undistributed income from non-genuine arrangements are included in a shareholder's income if obtaining a tax advantage is an essential purpose of the arrangement. Germany, for instance, has apparently opted for this slightly stricter approach.

Whether an arrangement is non-genuine is determined by reference to the staffing and performance of persons assigned to the C.F.C. or by the persons of the controlling company. The income to be included is based on the value of the functions performed by the staff of the controlling company. A *de minimis* rule applies so that companies with accounting profits that do not exceed 10% of the total income of the controlled company, provided that such amount does not exceed €80,000, are not covered by the C.F.C. rule.

### Hybrid Mismatches

A hybrid mismatch results from two jurisdictions giving different legal characterization to a business form – *viz.*, whether a permanent establishment exists – or a business transaction – *viz.*, whether a payment is deductible interest or dividends paid on a participation. This may lead to a situation where



- a deduction of the same payment, expenses, or losses occurs both in the jurisdiction in which the payment has its source, the expenses are incurred, or the losses are suffered, and in another jurisdiction (double deduction);
- a deduction of a payment occurs in the jurisdiction in which the payment has its source without a corresponding inclusion of the same payment in another jurisdiction (deduction without inclusion); or
- no taxation occurs on income in its source jurisdiction without inclusion in another jurisdiction (no taxation without inclusion).

Where a double deduction exists between two Member States, a deduction will be allowed only in the Member State where the payment has its source. In relation to third countries, the Member State generally denies the deduction. Where there is a deduction without inclusion between two Member States, no deduction will be allowed. In relation to third countries, the Member State denies the deduction if it is the source jurisdiction, and, generally, it includes the payment in its tax base if the third country is the source jurisdiction. Where nontaxation without inclusion exists, the jurisdiction where the business is resident includes the income in its tax base.

In respect of its territorial scope, A.T.A.D. 1 was limited to hybrid mismatches that arise in interaction between two Member States. Provisions concerning hybrid mismatches involving third countries were not included. In order to fix this insufficient territorial scope, the E.U. Council adopted A.T.A.D. 2,<sup>150</sup> which aims at neutralizing also tax effects from hybrid mismatches involving third countries, consistent with the recommendations outlined in the O.E.C.D. B.E.P.S. Report on Action 2.<sup>151</sup>

In addition to the broadening of the territorial scope, the amended provisions<sup>152</sup> now also address further types of hybrid mismatches which were not yet covered by the anti-tax avoidance measures in A.T.A.D. 1. The rules on hybrid mismatches are divided into three provisions as follows:

- **Hybrid Mismatches:**<sup>153</sup> Article 9 already existed under A.T.A.D. 1, the amended version now acts as a catch-all element tying on the broadly defined terms “hybrid mismatch” and “hybrid transfer.” In comparison to the original scope the provision additionally covers the following structures:
  - **Hybrid Permanent Establishment Mismatches:** Two jurisdictions differ on whether a business activity is being carried out through a permanent establishment.
  - **Hybrid Transfers:** Two jurisdictions differ on whether the transferor or the transferee of a financial instrument has the ownership of the payments on the underlying asset.



<sup>150</sup> Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

<sup>151</sup> O.E.C.D. (2015), *Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D., Paris.

<sup>152</sup> Council Directive 2016/1164/E.U. as amended by Council Directive 2017/952/E.U., art. 9a, 9b.

<sup>153</sup> *Id.*, art. 9.

- **Imported Mismatches:** The effect of a hybrid mismatch between parties in third countries is shifted into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralize hybrid mismatches.
- **Reverse Hybrid Mismatches:**<sup>154</sup> Reverse hybrid mismatch structures occur where an entity is incorporated or established in a Member State that qualifies the entity as transparent and a direct or indirect interest in 50% or more of the voting rights, capital interest or rights to a share of profit is held in aggregate by one or more associated nonresident entities located in a third country that regards the entity as non-transparent. Pursuant to Article 9a(1) the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction. This provision shall not apply to a collective investment vehicle, *i.e.*, an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.<sup>155</sup>
- **Tax Residency Mismatches:**<sup>156</sup> The taxpayer is resident for tax purposes in two (or more) jurisdictions. A deduction for payment, expenses or losses from the tax base of this taxpayer is possible in both jurisdictions. Article 9b directs the Member State of the taxpayer to deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If both jurisdictions are Member States, the Member States where the taxpayer is not deemed to be a resident according to the D.T.C. between the two Member States concerned shall deny the deduction.

Member States are required to adopt the A.T.A.D. 2 into their domestic tax law by January 1, 2020 and, in respect of the reverse hybrid mismatch rules, by January 1, 2022.

### Proposed “Unshell” Directive

On December 22, 2021, the E.U. Commission published a proposal for a directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/E.U. (the “Unshell Directive,” or A.T.A.D. 3).<sup>157</sup> On January 17, 2023, the European Parliament approved the European Commission’s proposal, as amended by the Committee on Economic and Monetary Affairs (“E.C.O.N.”).<sup>158</sup> The key element of the proposal is a threefold substance test to assess whether an entity will be deemed a shell company. The principles of this substance test are as follows:

- In the first step, an entity will fail substance requirements if more than 65% of its income consists of income from financial assets, intellectual or intangible

<sup>154</sup> *Id.*, art. 9a. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.

<sup>155</sup> *Id.*, art. 9a §2.

<sup>156</sup> *Id.*, art. 9b.

<sup>157</sup> E.U. Commission Communication COM (2021) 565 final (December 2021).

<sup>158</sup> European Parliament legislative resolution of January 17, 2023, on the COM (2021) 565 Final.

property, dividends and capital gains from shares, or other categories of income from specific outsourced activities.

- An entity will fail the second step of the test if at least 55% of its income is received through transactions involving more than one jurisdiction or passed on to entities that are not resident in the same jurisdiction as the entity under review.
- The third and final step will be failed if the entity has outsourced its administration of day-to-day operations and decision-making on significant functions within the last two tax years.

If the entity is deemed to be a shell company, it will need to declare a minimum level of substance in the Member State of its tax residence. Otherwise, the company will lose the protection of double taxation agreements between its Member State and other Member States of the E.U., as well as any tax relief based on E.U. Directives.

### Proposed “DEBRA” Directive

As a further amendment to the communication on B.E.F.I.T.,<sup>159</sup> on May 11, 2022 the E.U. Commission tabled a proposal for a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes (the “DEBRA Directive”).<sup>160</sup> The European Parliament approved the Commission’s proposal with certain amendments.<sup>161</sup> The directive addresses the predominate use of debt rather than equity for financing investments. This is sometimes favored due to an asymmetry in tax treatment, since tax systems in the E.U. allow the deduction of interest payments on debt when calculating the tax base for corporate income tax purposes, while costs related to equity financing, such as dividends, are mostly not tax deductible. Therefore, to reduce tax-induced debt-equity bias, the directive lays down rules to allow the deduction for tax purposes of notional interest on increases in equity, and to limit the tax deductibility of exceeding borrowing costs. The new rules shall apply to all taxpayers subject to corporate tax in one or more E.U. Member States, except for financial undertakings. It has been proposed for small- and medium-sized enterprises to get a higher notional interest rate, due to the typically higher burdens they face to obtain financing.

## SIMPLIFICATION OF EUROPEAN TAX LAW

In recent years, the E.U. has also sought to reduce compliance costs and simplify the European tax system.

On July 15, 2020, the Commission set out an action plan for fair and simple taxation (the “Simple Taxation Action Plan”).<sup>162</sup> Since that time, the Commission has presented a series of concrete proposals designed to simplify European tax law and reduce compliance costs. For instance, the B.E.F.I.T Proposal was introduced

*“The new rules shall apply to all taxpayers subject to corporate tax in one or more E.U. Member States, except for financial undertakings.”*

<sup>159</sup> See **Framework for Business Taxation (“B.E.F.I.T.”)**, above.

<sup>160</sup> Commission Proposal for a Council Directive on a debt-equity bias reduction, COM (2022) 216 Final (May 2022).

<sup>161</sup> European Parliament legislative resolution of January 16, 2024, on the COM (2022) 216 Final (May 2022), T.A./2024/0006.

<sup>162</sup> Commission Communication, COM (2020) 312 Final (July 2020).

with the intention of reducing compliance costs.<sup>163</sup> The proposal for a Council Directive on Faster and Safer Relief of Excess Withholding Taxes<sup>164</sup> also aims to reduce compliance costs.<sup>165</sup> For small and medium-sized enterprises, the Commission has proposed the introduction of a head office tax system.<sup>166</sup> Its primary objective is to reduce compliance costs for small and medium-sized enterprises.<sup>167</sup>

## 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 European 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 will likely reduce the opportunities for taxpayers to gain benefits through divergent tax treatment in two or more jurisdictions.



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<sup>163</sup> COM (2023) 532 Final, No. 1 “Reasons for and objectives of the proposal.”

<sup>164</sup> COM (2023) 324 Final.

<sup>165</sup> *Id.*, No. 2 second Point “Subsidiarity.”

<sup>166</sup> COM (2023/320) Final.

<sup>167</sup> *Id.*, No. 1.

## LUXEMBOURG

**Author**  
Rutger Zaal  
AKD  
Luxembourg

Over the last few decades, Luxembourg has been extremely popular as a holding and financing jurisdiction for both E.U. and non-E.U. investors, as well as an attractive location for collective investment funds and their managers. Its position as an important financial center, and the professional environment it offers, combined with attractive tax treatment and corporate flexibilities, give Luxembourg a leading role worldwide in investment funds and as a preferred European jurisdiction for holding, financing, and private wealth management activities.

Under Luxembourg law, a variety of legal forms and fund regimes are available and suitable for holding, financing, 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 a company having share capital, a S.O.P.A.R.F.I. is fully subject to Luxembourg income tax and net worth tax. Profit distributions by a S.O.P.A.R.F.I. are, in principle, subject to a 15% Luxembourg dividend withholding tax. A S.O.P.A.R.F.I. generally is, entitled to the benefits of the tax treaties concluded between Luxembourg and other countries and the E.U. tax directives.

Another attractive investment vehicle is a private wealth management company - *société de gestion de patrimoine familial regime* (“S.P.F.”). In contrast to the S.O.P.A.R.F.I., an S.P.F. is fully exempt from Luxembourg corporate income, net worth, and withholding taxes but is neither eligible for protection under the Luxembourg bilateral tax treaties nor covered by the E.U. tax directives.

Luxembourg law further provides for several collective investment vehicles. One 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.”). A second regime applies to specialized investment funds (“S.I.F.”). This regime is designed for well-informed investors. A third regime applies to reserved alternative investment funds (“R.A.I.F.”). It provides lighter establishment guidelines and more flexible corporate and operating regulations fitting the needs of alternative investment fund (“A.I.F.”) managers and investors. A fourth regime provides a legal and regulatory framework for securitization vehicles (“*sociétés de titrisation*”) coupled with a favorable tax regime. The S.I.C.A.R., the S.I.F., the R.A.I.F., and the securitization vehicle will be discussed in their respective sections, below. In addition, Luxembourg non-regulated funds are often set up under the form of a Luxembourg (special) limited partnerships or “*société en commandite (spéciale)*.”

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## GENERAL

### Income Tax

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 24.94%. This rate includes the 17% national corporation income tax (“C.I.T.”), plus the 6.75% Luxembourg City municipal business tax (“M.B.T.”), and a 7% unemployment fund surcharge.

### 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, evaluated on the basis of the company’s balance sheet as of December 31 of the preceding year. A reduced rate of 0.05% applies for taxable net wealth in excess of €500 million.

Certain assets are excluded, such as shares in a participation, provided that the participation exemption for dividend income is applicable, as described in **Participation Exemption** below. Note, however, that there is no minimum holding period requirement with regard to the net worth tax exemption.

A fixed minimum net worth tax applies, set at €4,815 (including a 7% surcharge), based on the closing balance sheet of the preceding year, when the resident corporate taxpayer’s financial assets for the prior year exceeded 90% of its total balance sheet and the balance sheet total exceeds €350,000, which is the case for most holding and financing companies.<sup>1</sup> In all other cases, the minimum tax is contingent on the balance sheet total of the resident corporate taxpayer, varying from €535 to €32,100, the latter maximum applying in case of a balance sheet total exceeding €30 million.

If a S.O.P.A.R.F.I. is part of a Luxembourg fiscal unity, both the parent company and its subsidiaries that are part of the fiscal unity are subject to the net worth tax, including the minimum amount. However, the aggregate minimum tax payable by a fiscal unity is capped at €32,100. Each member of the fiscal unity is fully liable for its own tax and the tax of its subsidiaries within the fiscal unity, including interest and penalties for late tax payments.

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<sup>1</sup> In a decision of the Luxembourg Constitutional Court from November 10, 2023 (185/23), the unconstitutionality of this provision of the law has been confirmed. Pending amendments to the law, the taxpayers whose balance sheet total is between €350,000 and €2,000,000, previously subject to the €4,815 minimum net worth tax will be subject to a minimum net worth of €1,605. A draft bill (number 8388) has been presented before the Luxembourg Parliament, further explained in **Recent and Current Developments**.

Subject to certain conditions, a S.O.P.A.R.F.I can credit part of its preceding year C.I.T. against the net worth tax of a given year. The S.O.P.A.R.F.I must create a non-distributable reserve of five times the amount of the credit it is seeking and must retain the reserve for at least five years.

### **C.F.C.**

As far as the C.F.C. legislation is concerned, Luxembourg implemented option B, as set out in A.T.A.D. (as defined below) which provides that where a C.F.C. has been put in place for the purpose of obtaining a tax advantage, Luxembourg corporate taxpayers will be subject to C.I.T. on the undistributed net income of a C.F.C., *pro rata* to their ownership or control of the foreign branch or the indirectly-held subsidiary, but only to the extent such income is related to significant functions carried out by the Luxembourg corporate taxpayer. To the extent that a Luxembourg company can establish that it does not perform significant functions related to the C.F.C.'s activities, the C.F.C. rules should not have an adverse tax impact.

### **Hybrid Mismatch Rules and Reverse Hybrid Mismatch Rules**

Hybrid mismatch rules introduced on the basis of A.T.A.D.<sup>2</sup> seek to prevent mismatch outcomes that arise as a consequence of the hybrid nature of a financial instrument, legal entity, or permanent establishment (“P.E.”). Targeted mismatch outcomes are deduction non-inclusion, double deduction, and double nontaxation outcomes. The main concern in Luxembourg will be (i) the potential denial of deduction of a payment made under a hybrid instrument or made by/to a hybrid entity and (ii) the application of corporate income tax on all or part of the income of Luxembourg transparent entities.

For the “ordinary” hybrid rules to apply, the mismatch must arise between associated entities or as part of a structured arrangement. When a person acts together with another person with respect to the voting rights or capital ownership in an entity, their participations in the entity will be aggregated in order to determine whether they are “associated” with that entity.<sup>3</sup>

Upon request, taxpayers must provide the tax administration with relevant documentation reasonably proving the absence of a hybrid mismatch or that another country has already tackled the hybrid mismatch. Relevant documents include tax returns and certificates from foreign tax authorities.

*“Hybrid mismatch rules introduced on the basis of A.T.A.D. seek to prevent mismatch outcomes that arise as a consequence of the hybrid nature of a financial instrument, legal entity, or permanent establishment.”*

<sup>2</sup> Effective January 1, 2019, Luxembourg, implemented the Anti-Tax Avoidance Directive (2016/1164) (“A.T.A.D.”) and Anti-Tax Avoidance Directive 2 (2017/952) (“A.T.A.D.”). A.T.A.D. 1 and A.T.A.D. 2 form the E.U.-wide implementation of Action 2 of the O.E.C.D.’s work on base erosion and profit shifting (“B.E.P.S.”), which called for rules to neutralize the effects of hybrid mismatch arrangements through deduction limitations and a general anti-abuse rule.

<sup>3</sup> Luxembourg law provides that, in the absence of evidence to the contrary, an investor who directly or indirectly owns less than 10% of the interests in an investment fund and is entitled to less than 10% of the profits of the fund will not be considered as acting together with other investor(s) in the same fund.

## PARTICIPATION EXEMPTION

A S.O.P.A.R.F.I. may be entitled<sup>4</sup> to the benefits of the Luxembourg participation exemption, which grants a 100% exemption for dividends and gains (including foreign exchange gains) realized from qualifying subsidiaries. The participation exemption also applies to dividends received and gains realized on participations that are attributed to a Luxembourg permanent establishment of a resident of (i) an E.U. Member State or (ii) a country in which it is subject to tax, as discussed in **Subject to Tax**.

### **Dividends**

According to Article 166 of the Luxembourg Income Tax Act (“I.T.A.”), dividends (including liquidation proceeds) 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) an entity falling within the scope of Article 2 of the E.U. Parent-Subsidiary Directive (2011/96/E.U.), as amended from time to time, (the “P.S.D.”)<sup>5</sup> or a permanent establishment thereof, provided the hybrid loan provision and the general anti-abuse rule known as the “G.A.A.R.” do not apply (please see below), (b) a fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D., or (c) a non-Luxembourg capital company subject in its country of residence to a profit tax comparable to Luxembourg’s C.I.T. in terms of rate and taxable basis (the “Comparable Tax Test”). See **Subject to Tax**, below, for further details.

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).

Regarding the second condition described in item (ii)(a) above, the Luxembourg participation exemption was amended in line with the revised P.S.D.<sup>6</sup> and includes a provision countering hybrid loan arrangements and implementing the G.A.A.R. The hybrid loan provision aims at preventing double non-taxation via the use of hybrid financing arrangements by limiting the exemption of payments received through such arrangements if such payment is deducted in another E.U. Member State. The G.A.A.R. requires E.U. Member States to refrain from granting the benefits of the P.S.D. to certain arrangements that are not “genuine.” For the arrangement to be

<sup>4</sup> On May 23, 2024, a draft bill of law (number 8388) was presented introducing the possibility to opt-out from the application of the participation exemption, further explained in **Recent and Current Developments**.

<sup>5</sup> A company is covered by article 2 of the P.S.D. when it takes one of the forms listed in the Annex I to the P.S.D., is tax resident in a Member State, is not considered tax resident elsewhere, and is subject to tax without the possibility of an option to be exempt or actually being exempt.

<sup>6</sup> The P.S.D. was amended in 2014 and 2015 by Council Directive 2014/86/E.U. and Council Directive 2015/121, respectively. By law of December 18, 2015, and effective January 1, 2016, such amendments were implemented in the I.T.A.



non-genuine, one of its main purposes must be to obtain a tax advantage that would defeat the object or purpose of the P.S.D. Therefore, dividends received by a Luxembourg taxpayer from a subsidiary in the E.U. (including in principle Luxembourg subsidiaries) are not exempt if they are deductible by the E.U. subsidiary distributing the dividend. In addition, when the P.S.D.-based participation exemption is applied, the dividend arrangement must not violate the G.A.A.R. in order for the exemption to apply. The G.A.A.R. should not apply to distributions from a Luxembourg company to another Luxembourg company that is normally subject to tax.

The Luxembourg domestic participation exemption could be viewed as still being available notwithstanding the G.A.A.R. if the subsidiary meets the Comparable Tax Test referred to above, and further detailed in **Subject to Tax** below, in the context of an income tax treaty, which should be the case for many E.U. Member State subsidiaries.

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, regarding the application of Article 166 I.T.A., capital gains (including foreign exchange 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) an entity falling within the scope of Article 2 of the P.S.D. or a permanent establishment thereof, (ii) a fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D., or (iii) a non-Luxembourg capital company meeting the Comparable Tax Test.
- 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.

The capital gains exemption is not subject to the G.A.A.R. as implemented in Luxembourg law following the amendments to the P.S.D., as the latter only relates to dividends and not capital gains.

## **SUBJECT TO TAX**

As outlined above, in order to qualify for the Luxembourg participation exemption on dividends and capital gains, nonresident subsidiaries should either qualify under Article 2 of the P.S.D. or must be subject to a comparable tax in their country of residence, (“ the Comparable Tax Test”).

Based on parliamentary history, the Comparable Tax Test requires that the nonresident subsidiary (i) be subject to a tax rate of at least half the Luxembourg C.I.T. rate



(i.e., currently at least 8.5%) and (ii) be subject to tax on a basis that is determined in a manner comparable to the determination of the taxable basis in Luxembourg. It is not fully clear whether the Comparable Tax Test should be applied on the basis of an effective rate or tax base. Furthermore, no list of qualifying countries exists for this purpose. Where comparability is unclear, an advance tax agreement (“A.T.A.”) can be requested from the Luxembourg tax authorities (“L.T.A.”).

Beyond the domestic participation exemption, certain treaties concluded by Luxembourg contain a lower rate or a participation exemption for dividends, without a Comparable Tax Test being required. 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 the period required under Luxembourg law (e.g., the beginning of the accounting year versus 12 months). Application of these more favorable treaty provisions is subject to the Multilateral Instrument applying as discussed below in **Withholding Tax in a Foreign Subsidiary’s Country**.

## TAX-FREE REORGANIZATIONS

The Luxembourg I.T.A. provides for certain reorganizations that are viewed as tax-free in the hands of shareholders of certain capital companies (i.e., application of a roll-over). Included are (i) transformations of a capital company into another capital company whereby securities of the transformed company are issued to the shareholder, (ii) mergers or demergers of capital companies or companies resident in an E.U. Member State whereby securities of the merged company are issued to shareholders of the disappearing company, and (iii) certain share-for-share exchange transactions.

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

In the cases described above (other than the second), 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 the year in which one of the foregoing transactions occurs, 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 exchange transaction.

## EXIT TAXATION

The scope of Luxembourg’s existing exit tax payment deferral rules cover the transfer from or to Luxembourg of (i) corporate assets, (ii) corporate tax residence, and (iii) permanent establishment. In line with A.T.A.D. 1 and 2, a five-year payment deferral will apply to transfers to an E.U./European Economic Area jurisdiction.

In the case of transfer of assets to Luxembourg (whether from an E.U. or non-E.U. jurisdiction), the tax book value of the assets transferred equals the value used by the exit state, unless that value does not reflect the fair market value of the assets. No guarantee requirement or interest applies to the deferral. Exit tax payment deferrals granted for periods ending before January 1, 2020, are grandfathered.

Upon migration out of Luxembourg, the migrating company is deemed liquidated and its assets and liabilities will be realized at fair market value.

## LUXEMBOURG PERMANENT ESTABLISHMENT

Under domestic law, and in absence of any tax treaty, profits of a P.E. of a Luxembourg-resident taxpayer are included in the taxable basis and a credit for underlying tax is available. Where a Luxembourg-resident taxpayer has a P.E. in another country, the relevant tax treaty generally provides for an exemption in Luxembourg of the profits of the P.E. The L.T.A. can challenge the application of the exemption of income allocable to a P.E. under an applicable tax treaty. The L.T.A. may ask for proof of existence of the P.E. from the treaty partner jurisdiction. Such proof is mandatory if the tax treaty does not have a clause that allows Luxembourg to deny the exemption under the applicable treaty if the other treaty partner does not impose tax on the income. Administrative guidance from the L.T.A. makes it clear that the absence of such confirmation will result in the denial of the P.E. exemption. Obtaining such proof should be closely monitored.

*“Under domestic law, and in absence of any tax treaty, profits of a P.E. of a Luxembourg-resident taxpayer are included in the taxable basis and a credit for underlying tax is available.”*

## PARTIAL PARTICIPATION EXEMPTION

An interest of less than 10% in a subsidiary 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 does not qualify for the participation exemption described above. However, dividend income derived from such interests may be eligible for a 50% exemption, provided that such dividends are distributed by (i) a fully taxable Luxembourg capital company, (ii) a capital company resident in a treaty country which is subject to a profit tax comparable to the Luxembourg C.I.T., or (iii) a company resident in an E.U. Member State and falling within the scope of Article 2 of the P.S.D. The exemption applies to the net dividend income which corresponds to the dividend received minus costs related to the participation incurred in the same year.

## WITHHOLDING TAX IN A FOREIGN SUBSIDIARY'S COUNTRY

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

As of the date of this article, Luxembourg has 85 income tax treaties in force with the following jurisdictions:

|                |               |              |                      |
|----------------|---------------|--------------|----------------------|
| Andorra        | Germany       | Malta        | South Africa         |
| Armenia        | Greece        | Mauritius    | South Korea          |
| Austria        | Guernsey      | Mexico       | Spain                |
| Azerbaijan     | Hong Kong     | Moldova      | Sri Lanka            |
| Bahrain        | Hungary       | Monaco       | Sweden               |
| Barbados       | Iceland       | Morocco      | Switzerland          |
| Belgium        | India         | Netherlands  | Taiwan               |
| Botswana       | Indonesia     | Norway       | Tajikistan           |
| Brazil         | Ireland       | Panama       | Thailand             |
| Brunei         | Isle of Man   | Poland       | Trinidad & Tobago    |
| Bulgaria       | Israel        | Portugal     | Tunisia              |
| Canada         | Italy         | Qatar        | Turkey               |
| China          | Japan         | Romania      | Ukraine              |
| Croatia        | Jersey        | Russia       | United Arab Emirates |
| Cyprus         | Kazakhstan    | San Marino   | United Kingdom.      |
| Czech Republic | Kosovo        | Saudi Arabia | United States        |
| Denmark        | Laos          | Senegal      | Uruguay              |
| Estonia        | Latvia        | Serbia       | Uzbekistan           |
| Ethiopia       | Liechtenstein | Seychelles   | Vietnam              |
| Finland        | Lithuania     | Singapore    |                      |
| France         | Macedonia     | Slovakia     |                      |
| Georgia        | Malaysia      | Slovenia     |                      |

Additionally, Luxembourg is in the process of negotiating 12 new income tax treaties, seven of which have already been signed.

Luxembourg signed the Multilateral Instrument on June 7, 2017. On February 14, 2019, the Luxembourg parliament adopted the law ratifying the Multilateral Instrument, and the O.E.C.D. was notified on April 9, 2019. Nearly all of Luxembourg's treaties are so-called covered tax agreements.

Apart from certain compulsory provisions tackling treaty abuse scenarios, such as an introduction of the principal purpose test ("P.P.T."), Luxembourg accepted only a few optional rules included in the Multilateral Instrument. Luxembourg has sought to limit the scope and impact of the Multilateral Instrument to the minimum standards required.

In particular, Luxembourg has chosen option A in relation to Article Item 5 (Application of Methods for the Elimination of Double Taxation) and the P.P.T. without applying the limitation on benefits clause in relation to Article Item 7 (Prevention of Treaty Abuse). Luxembourg will not apply Article Item 4 (Dual Resident Entities), Article Item 8 (Dividend Transfer Transactions), Article Item 9 ('Real Estate Rich' Company Clause), Article Item 10 (Anti-Abuse Rule for Permanent Establishments situated in Third Jurisdictions), Article Item 11 (Savings Clause), Article Item 12 (Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements),

Article Item 14 (Splitting Up of Contracts), or Article Item 15 (Definition of a Closely Related Persons).

Based on the signatories and parties to the Multilateral Instrument, as of June 5, 2024, 70 tax treaties concluded by Luxembourg have been affected by the Multilateral Instrument and the Multilateral Instrument is now in effect in respect of those treaties.

## DEDUCTION OF COSTS

### **Value Adjustments**

A S.O.P.A.R.F.I. may make deductible value adjustments for a participation. The deductions can be used to offset other income and may result in tax losses. Losses that were incurred before 2017 may be carried forward indefinitely while the carry-forward of losses incurred as of January 1, 2017, is limited to 17 years after the losses occurred. Carryback of losses is not allowed.

Value adjustment and other expenses linked to a participation that qualifies for the participation exemption and which have been deducted in prior years or in the year of the sale are recaptured. This means that the capital gains exemption described in **Capital Gains** above does not apply to the extent of the deducted amounts. As a result, capital gains arising from a disposition of shares may be taxable in part, but can be offset by available losses carried forward.

### **Financial Costs**

Financing expenses connected with qualifying participation are tax deductible to the extent that they exceed exempt income arising from the qualifying participation in a given year. To the extent deductible, the deduction can be used to offset other types of income but such expenses are subject to the recapture rule described above. In principle, expenses are allocated on an historic direct-tracing basis. Where direct tracing is not possible, expenses are allocated on a *pro rata* basis that looks to the relative value of each participation.

Realized currency gains and currency losses on loans obtained to finance the acquisition or further capitalization of subsidiaries are taxable or deductible. Therefore, currency exposure should be avoided, preferably by denominating such loans in the currency that the Luxembourg taxpayer applies as its functional currency for tax reporting purposes. Currency gains on the investment in the participation itself and, in principle, on repayments of capital, are exempt under the participation exemption. Unrealized currency losses on the investment and on repayments of capital are deductible but may cause the recapture rules to apply in a subsequent period.

The interest deduction limitation rules cap the deductibility of “excessive borrowing costs” at the higher of 30% of the E.B.I.T.D.A. or €3.0 million. This refers to the excess, if any, of a Luxembourg taxpayer’s deductible interest and economically equivalent expenses over its taxable interest income and economically equivalent income. Luxembourg companies that are part of a fiscal unity apply the interest deduction limitation rules at the level of the integrating company, unless a request is made for application at individual entity level.

The following three categories of Luxembourg taxpayers, *inter alia*, are excluded altogether from the application of the interest deduction limitation rules:

- A taxpayer that is a financial undertaking which is, *inter alia*, the case if the taxpayer is an A.I.F or a securitization vehicle in the sense of the E.U. regulation 2017/2402<sup>7</sup>
- A taxpayer that qualifies as a Standalone Entity, which means a taxpayer that is not part of a consolidated group for financial accounting purposes and has neither an Associated Enterprise nor a permanent establishment in another jurisdiction. An Associated Enterprise means (i) an entity (capital company, partnership, etc.) in which the taxpayer holds directly or indirectly 25% or more of the voting rights or capital ownership or is entitled to receive 25% or more of its profits or (ii) an individual or collective undertaking (capital company, partnership, etc.) which holds directly or indirectly 25% or more of the voting rights or capital ownership of the taxpayer or is entitled to receive 25% or more of the profits of the taxpayer.
- A taxpayer that qualifies for the “Group Ratio Exclusion,” which is the case if the following conditions are cumulatively met:
  - The taxpayer is a member of a consolidated group for financial accounting purposes.
  - The ratio of equity over total assets (the “Equity Ratio”) of the consolidated group does not exceed the Equity Ratio of the taxpayer by more than 2 percentage points (e.g., if the Equity Ratio of the consolidated group is 10%, this condition is met as long as the taxpayer’s Equity Ratio is at least 8%).
  - All assets and liabilities are valued using the same method as in the consolidated financial statements established in accordance with I.F.R.S. or the national financial reporting system of an E.U. Member State.
  - The taxpayer has filed a request to benefit from the Group Ratio Exclusion.

Deductions claimed for interest and royalty payments accrued or paid by Luxembourg companies are disallowed when the recipient is resident in a blacklisted jurisdiction. The disallowance is subject to the following conditions:

- The recipient of the payment, or its beneficial owner if different, is not a tax transparent entity.
- The recipient (or beneficial owner) is a related enterprise.<sup>8</sup>

<sup>7</sup> The exemption for securitization vehicles is likely to be removed by the Luxembourg legislators pursuant to a pending bill, as a result of a letter of formal notice sent under scrutiny by the E.U. Commission on March 9, 2022. However, it has not been removed as of the date of this writing. It is likely to be amended or deleted.

<sup>8</sup> The concept of related enterprises is consistent with adopted for transfer pricing concepts (*i.e.*, two entities that are participating in each other or in the same company through capital, control, or management).



- The recipient (or beneficial owner) is established in a jurisdiction which is included on the list of noncooperative tax jurisdictions.

The taxpayer's deductions will not be disallowed if it proves that the transaction is motivated by valid business reasons reflecting economic reality.

The Luxembourg list of noncooperative tax jurisdictions is the E.U. blacklist. It is revisited only at each year end. Therefore, if a country is added during a year, it will first be included in the list only as of the beginning of next following year. If a country is added and subsequently removed from a list during a year, it will not be put in the list of the next following year. If a country is removed from the E.U. list, the removal will take effect from the date of publication of the removal by the E.U.

### **Liquidation Losses**

A loss realized upon liquidation of a participation is deductible.

## **WITHHOLDING TAX ON OUTBOUND DIVIDENDS AND CAPITAL GAINS**

### **Distributions on Shares**

Distributions made on shares by a S.O.P.A.R.F.I. are subject to Luxembourg dividend withholding tax imposed at the rate of 15%, unless a domestic exemption or a reduced treaty rate applies (see below with respect to liquidation distributions). Under Article 147 of the I.T.A., exemptions may apply for dividend distributions from a Luxembourg company, if certain conditions are met, to one of the following entities:

- An entity falling within the scope of Article 2 of the P.S.D., or a permanent establishment thereof.
- A fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D.
- A Swiss-resident capital company that is subject to corporation tax in Switzerland without benefiting from an exemption.
- A company resident in a treaty country and meets the Comparable Tax Test as discussed in **Subject to Tax**, above.

Such distributions are exempt from Luxembourg dividend withholding tax if the following two conditions apply. The first is that the dividend is paid to one of the above-mentioned qualifying entities that holds 10% or more of the issued share capital of the Luxembourg company (whether via an entity that is transparent for Luxembourg tax purposes or not), or the participation has an acquisition cost of at least €1.2 million. The second is that 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.<sup>9</sup>

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<sup>9</sup> In recent practice, prior to the completion of the 12-month holding period, the L.T.A. may request that the fulfillment of this requirement be guaranteed by way of a commitment letter from the shareholder.

Shareholders that are considered as transparent for Luxembourg tax purposes should be disregarded when determining whether the above conditions are met. Instead, the most immediate indirect shareholder that is not tax transparent should be regarded as owning the participation in the Luxembourg company.

In a manner that is similar to testing the application of the participation exemption discussed above in **Participation Exemption** before an exemption from withholding tax on dividends is applied to an E.U.-resident corporation, the arrangement by which the S.O.P.A.R.F.I. is held must be tested under the European G.A.A.R. of the P.S.D. as implemented in Luxembourg law. An improper, non-commercial purpose for the holding may prevent the application of the exemption. For non-E.U. shareholders, no such test is applicable. In addition, the Luxembourg domestic withholding tax exemption may be available notwithstanding the G.A.A.R., if the shareholder meets the Comparable Tax Test as referred to above in this section and further detailed above in **Subject to Tax**, which should be the case in the context of an income tax treaty as well as for many shareholders that are entities resident in an E.U. Member State. In this respect, the potential impact of the Multilateral Instrument must be taken into account as discussed in **Withholding Tax in a Foreign Subsidiary's Country** and recent case law of the E.C.J. discussed in **Dividends**.

### **Interest Payment on Straight and Hybrid Debt**

Arm's length 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, interest paid on loans when sharing in a company's overall profit, is subject to 15% withholding tax, unless a lower tax treaty rate applies.

### **Capital Gains in Hands of Shareholders**

Resident individual shareholders are taxable on the disposition of shares (including by way of liquidation) in a S.O.P.A.R.F.I. where (i) the disposition or total or partial liquidation produces a speculation gain because it takes place within six months of acquisition or (ii) the individual directly or indirectly owns a substantial interest in the S.O.P.A.R.F.I.

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

Nonresident shareholders who do not have a Luxembourg permanent establishment to which shares in a S.O.P.A.R.F.I. – and income or gain related to the shares – are attributed are subject to Luxembourg capital gains tax on the disposition of shares only when the shareholding is considered to be a substantial interest and (i) the disposition or liquidation gives rise to a speculation gain as previously defined or (ii) 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 disposition or liquidation. Nonetheless, Luxembourg may not be entitled to tax this gain under provisions of applicable tax treaties.



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

A repurchase of shares in a S.O.P.A.R.F.I. should be considered as a capital gain; it generally is not subject to Luxembourg dividend tax. However, a case dated 2017<sup>10</sup> held that the repurchase could be viewed in certain circumstances as a “simulated” dividend that is subject to dividend tax if no exemption applies. Typically, this occurs when the repurchase price is not supported by valid economic principles or when the repurchase should be viewed as a fictional or simulated transaction intended to distribute profits to the shareholder.

The risk becomes remote when there is a redemption of all the shares held by the shareholder. In this fact pattern the repurchase is considered to be a capital gain, that is not subject to Luxembourg dividend tax (the “partial liquidation”) by virtue of Article 101 of the I.T.A.

In addition, the repurchase and immediate subsequent cancellation of an entire class of shares from a shareholder owning several classes is considered a sale, triggering capital gains tax and therefore not subject to withholding tax to the extent the repurchase price does not exceed the fair value.<sup>11</sup> Any excess of value would be treated as a hidden dividend distribution, subject to withholding tax.

*“Luxembourg law does not contain any provisions regarding debt-to-equity ratios, other than the general arm’s length principle.”*

## OTHER TAX ISSUES

### Debt-to-Equity Ratio

Luxembourg law does not contain any provisions regarding debt-to-equity ratios, other than the general arm’s length principle. However, a debt-to-equity ratio of at least 85:15 is generally required by the L.T.A. for the financing of qualifying participations. If a higher ratio is maintained, a portion of the interest payments may be considered as a deemed dividend, which will not be deductible for Luxembourg corporation income tax purposes, and, depending on the case, a Luxembourg dividend withholding tax obligation may arise.

In addition, L.T.A. have published a Circular in transfer pricing matters which is discussed below in **Transfer Pricing Regulations**. The circular requires intragroup financing companies to be funded with an appropriate amount of equity in order to have the financial capacity to assume the economic risks of loan investments, but does not specify what an appropriate amount of equity is or the process to determine whether equity is appropriate. Thus, the amount of equity to be contributed to a group financing company is a factual question and should be determined on a case-by-case basis.

### Transfer Pricing Regulations

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,

<sup>10</sup> Administrative Court, March 3, 2017, no. 39193C.

<sup>11</sup> Administrative Tribunal, January 27, 2023, no. 42432 and Administrative Tribunal, June 14, 2023, number 45759. Further to the decisions mentioned, on May 23, 2024, a draft bill (number 8388) has been presented in the Luxembourg parliament, introducing provisions to I.T.A. on redemption of entire class of shares, further explained in **Recent and Current Developments**.

and Article 56bis of the I.T.A. as of January 1, 2017. The wording of Article 56 of the I.T.A. is based on Article 9 of the O.E.C.D. Model Tax Convention. The legislation stipulates that upon the request of the tax authorities, the taxpayer is obliged to present relevant information underlying the transfer prices agreed by associated enterprises. Based on the literal wording of Article 56, some taxpayers have argued that Luxembourg companies should be allowed to deduct deemed interest expense on interest-free debt for C.I.T. and M.B.T. purposes. Not surprisingly, the argument was challenged by the European Commission (“the Commission”) in the Huhtamaki case discussed below in **State Aid Investigations by the European Commission**.

Article 56bis of the I.T.A. lays down the basic principles for a transfer pricing analysis. These principles are in line with the O.E.C.D. transfer pricing guidelines and Action 8 through 10 of the B.E.P.S. Action Plan.

On December 27, 2016, the L.T.A. published a Circular to Articles 56 and 56bis of the I.T.A., reshaping the rules for Luxembourg companies engaged in intragroup financing activities. The Circular clarified the L.T.A.’s interpretation of provisions regarding intragroup financing activities. According to the Circular, intragroup financing activities comprise all interest-bearing lending to related companies that are funded with financial instruments in- or outside the group.

The guiding principles of the Circular are that intragroup financing companies must have the financial capacity to assume risks and the ability to control and manage such risks. With respect to the financial capacity, the previous circular generally considered a minimum amount of equity at risk equal to the lower of either 1% of the intragroup financing amount or €2.0 million to be adequate. The Circular, however, states that the appropriate amount of equity at risk should be determined on a case-by-case basis. On the control and management of risk, the Circular refers to adequate people-related functions. The specific substance requirements are broadly similar to those outlined in the previous circular: (i) Key decisions are made in Luxembourg, (ii) qualified personnel are adapted to the needs of the control of the transactions being carried out, (iii) a majority of board members are Luxembourg residents, (iv) at least one annual shareholder meeting is held in Luxembourg, and (vi) the company is not tax resident in another jurisdiction.

In addition, the Circular requires that the lending company should have an understanding of material risks that are undertaken.

The Circular provides for safe harbors in certain circumstances. An after-tax return on equity of 10% may reflect an arm’s length compensation for financing and treasury functions for companies with a functional profile similar to that of a regulated financial undertaking. This percentage will be reviewed and updated regularly by the Luxembourg direct tax authorities. For intragroup financing companies performing pure intermediary activities, transactions will be considered arm’s length if a minimum after-tax return of 2% on the amount of its financing activity. The Circular does not define pure intermediary activities. Intragroup financing companies will have the option to deviate from the foregoing standard based on a transfer pricing report.

Finally, the Circular states that all rulings and other individual administrative decisions in relation to the arm’s length principle will no longer be binding on the L.T.A. as of January 1, 2017, for tax years beginning after 2016. Whereas the Circular

addresses intragroup financing companies, the above statement is worded without restriction in scope. It is therefore unclear whether it targets more than just transfer pricing rulings obtained by intragroup financing companies.

Taxpayers wishing to have certainty on transfer pricing continue to have the option to file an A.P.A. with the Luxembourg direct tax authorities, as discussed in **Advance Tax Agreements and Advance Pricing Agreements**.

### **General Anti-Abuse Rule (“G.A.A.R.”)**

The wording of the existing domestic G.A.A.R. provision is in line with the A.T.A.D.’s wording, introducing the concept of a non-genuine arrangement. It will suffice for a tax advantage to be one of the main purposes of the arrangement to be caught under the G.A.A.R.

### **I.P. Regime**

On March 22, 2018, Luxembourg adopted a new I.P. regime set out in article 50ter I.T.A. (the “New I.P. Regime”) effective January 1, 2018. The New I.P. Regime applies to any Luxembourg tax resident carrying out a business activity in Luxembourg and owning qualifying I.P.

Eligible net income from qualifying I.P. assets may benefit from an exemption up to 80% from income taxes and a full exemption from net wealth tax. The eligible assets must have been developed or improved after December 31, 2007, and are limited to patents, utility models, supplementary protection certificates granted for a patent on medicine and plant protection, plant variety certificates, extensions of a complementary protection certificate for pediatric use, orphan drug designations, and software protected by copyrights.

The portion of the I.P. income benefiting from the advantageous tax treatment is calculated based on a ratio taking into account the R&D costs. The ratio corresponds to the eligible R&D costs divided by the overall R&D expenses. Luxembourg allows the eligible R&D costs to be uplifted by 30% insofar as the resulting ratio does not exceed the total amount of expenditure. Expenses must be incurred within the framework of an R&D activity, but need not be undertaken by the taxpayer. Outsourced activity is eligible for favorable treatment.

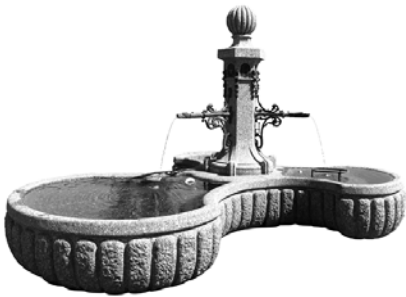
The New I.P. Regime is in line with the recommendations made by the O.E.C.D., and adopts a nexus approach to ensure that only the R&D activities having nexus with the Luxembourg taxpayer itself benefit from the New I.P. Regime.

Unlike the previous regime, I.P. assets of a marketing nature (e.g., trademarks) are excluded from the scope of the proposed regime.

The former I.P. regime was abolished in 2016 but continued to be applicable due to a grandfathering period of five years. Where the taxpayer is eligible under both regimes, the taxpayer may elect the I.P. regime to be applied during the transitional period (2018 to 2021). The option is irrevocable for the entire transitional period.

### **Real Estate Tax for Investment Vehicles**

Certain investment vehicles are subject to a real estate tax on income derived from real estate assets situated in Luxembourg. The tax is imposed at a flat rate of 20%.



The investment vehicles that are within the scope of this new tax are specialized investment funds (“S.I.F.”), so-called “Part II” undertakings for collective investment (“U.C.I.”) and reserved alternative investment funds (“R.A.I.F.”), provided the vehicle in issue is not a tax transparent partnership or a common placement fund (“F.C.P.”). The tax applies to income and gains derived from Luxembourg real estate assets held directly and indirectly via a partnership or an F.C.P.

Income derived from real estate assets income includes (i) gross rental income, capital gains upon the disposal of a Luxembourg real estate asset (at the moment of a sale, contribution, merger, liquidation, etc.) and (ii) income from the disposal of an interest in certain tax transparent entities (a partnerships or an F.C.P.), to the extent the value of the interest reflects the value of real estate located in Luxembourg. The tax is due in full even when the transaction is not accompanied by a cash payment as is the case in an intragroup restructuring.

The L.T.A. released an administrative circular which clarified the filing obligations required by the Real Estate Levy for Investment Fund Vehicles. As of May 31, 2022, all investment vehicles under the scope of the Real Estate Levy (*i.e.*, S.I.F.’s, U.C.I.’s and R.A.I.F.’s) need to respond to the following inquiries regarding real estate situated in Luxembourg:

- Did they own a real estate asset situated in Luxembourg during the years 2020 and 2021?
- Did they own a real estate asset situated in Luxembourg during the years 2020 and 2021 through a tax transparent entity or an F.C.P.?
- Did they change their corporate form during the years 2020 and 2021 to become tax transparent or adopt the form of an F.C.P., and did they own at least one real estate asset situated in Luxembourg, either directly or through a tax transparent entity or an F.C.P. at the moment of the change of form?

Investment vehicles inside the scope of the Real Estate Levy which hold Luxembourg real estate must file an annual return declaring the qualifying real estate income with a detailed breakdown of each property by May 31 of the following year.

### **Advance Tax Agreements and Advance Pricing Agreements**

The procedure to obtain an A.T.A. is codified into Luxembourg law. In an A.T.A., the L.T.A. confirm the 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 L.T.A.

A.T.A.’s obtained by a taxpayer are binding on the tax authorities unless one of the requirements set out in the law is no longer met. A.T.A.’s obtained prior to the introduction of the legal framework for obtaining advance confirmation in 2015 are in most cases valid indefinitely, unless (i) the circumstances or transactions were described incompletely or inaccurately, (ii) the circumstances or transactions that took place at a later stage differ from those underlying the A.T.A., or (iii) the A.T.A. is no longer compliant with national, E.U. or international law.

Subject to the foregoing requirements, case law<sup>12</sup> provides that an A.T.A. continues to bind the L.T.A. notwithstanding a change of policy under the following conditions:

- The question and fact pattern submitted to the tax authorities are clear and included all elements necessary to allow the tax authorities to make an informed decision.
- The decision was issued by a competent civil servant, or by a civil servant of which the taxpayer could legitimately believe that he was competent.
- The administration intended to bind itself, *i.e.*, the answer was given without restrictions or reservations.
- The answer provided by the administration must have had a decisive influence on the taxpayer.

However, a law voted on December 20, 2019, provides for the automatic expiration of A.T.A granted prior to 2015 expired upon completion of the 2019 tax year. Should taxpayers want similar comfort for subsequent tax years, a new request may be filed under the new procedure. The explicit language of the law to that effect seems to imply that the fact that a new ruling request would be filed only after the transaction had occurred should not be an obstacle to obtaining such a ruling.

As for intragroup transactions, the arm's length character of the remuneration to be earned by a Luxembourg company may be confirmed by the tax authorities in an advance pricing agreement ("A.P.A"). However, the issuance of an A.P.A. is subject to certain conditions, set out in an administrative circular issued by the L.T.A. on December 27, 2016 (the "Circular"). Such conditions include, *inter alia*, the following:

- The relevant employees or board members of the Luxembourg entity are qualified to carry out the functions and tasks assigned to the Luxembourg entity.
- The countries affected by the financing transactions have been listed.
- Full information has been provided regarding the parties involved in the controlled transaction.
- A detailed transfer pricing analysis has been submitted. See in this respect **Transfer Pricing Regulations**.

### **State Aid Investigations by the European Commission**

Over the last few years, the Commission has continued its examination of the A.T.A. and A.P.A. practices of various E.U. Member States, including Luxembourg, in light of the existence of unlawful State Aid by way of an A.T.A. or A.P.A. The Commission has repeatedly stated that an A.T.A. or A.P.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. or A.P.A. that grants State Aid is not allowed under the E.U. treaties. In that regard, it is generally unlawful for E.U. Member States to grant aid in the form of a tax advantage on a selective basis to undertakings. If unlawful aid was granted, the Commission can order the Member State to recover that aid from the beneficiary undertaking, with interest due on the collected amount, as if it were a loan.

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<sup>12</sup> Administrative Court, July 12, 2016, no. 37448C.

*“The Commission ordered Luxembourg to recover the unpaid tax from F.F.T. in order to remove the unfair competitive advantage they were granted and to restore equal treatment with other companies in similar situations.”*

Regarding Luxembourg, the Commission has investigated (or is investigating) A.T.A.’s issued to GDF Suez, Amazon, McDonald’s, Fiat Finance and Trade (“F.F.T.”), and Huhtamaki to determine whether A.T.A.’s amounted to unlawful State Aid.

On October 21, 2015, the Commission’s adverse decision with regard to the F.F.T. case was published (Decision C (2015) 7152 final), stating that Luxembourg granted selective tax advantages to F.F.T. The Commission ordered Luxembourg to recover the unpaid tax from F.F.T. in order to remove the unfair competitive advantage they were granted and to restore equal treatment with other companies in similar situations. In addition, F.F.T. can no longer continue to benefit from the tax treatment granted by these tax rulings. The E.U. General Court also upheld the Commission’s decision in the Fiat case, maintaining that Luxembourg granted unlawful State Aid to a Luxembourg treasury company of the Fiat group. The General Court criticized specific aspects of the transfer pricing position. In particular, it questioned the amount of equity deemed at risk, which was seemingly much lower than the equity in reality at risk, and the application of the equity at risk remuneration only to that small portion of equity deemed at risk.

On November 8, 2022, the Court of Justice of the E.U. delivered its judgment in the Luxembourg State Aid case concerning F.F.T. The Court of Justice annulled both the judgment of the General Court of the European Union and the Commission’s decision. The C.J.E.U. concluded that the Commission did not establish that Luxembourg granted a selective tax advantage to the financing company by agreeing in the A.T.A. concluded on June 9, 2016 to transfer prices that, according to the Commission, deviated from market practices. This case is the first to reach a final decision from the C.J.E.U. regarding the Commission’s investigations into alleged State Aid granted by E.U. Member States regarding direct tax.

On October 4, 2017, the Commission reached an adverse decision in the Amazon case (Decision (E.U.) 2018/859). The case concerns the arm’s length nature of royalty paid by a Luxembourg company to a Luxembourg partnership. The decision ordered Luxembourg to recover the granted State Aid from Amazon. Luxembourg challenged the decision to the European Union General Court (case T-816/17). On May 12, 2021, the General Court of the E.U. annulled the Commission decision. The Commission filed an appeal with the Court of Justice of the E.U. which was decided on December 14, 2023, in favor of the taxpayer. The E.U. Commission’s decision breached E.U. law and was annulled.

On June 20, 2018, the Commission reached an adverse decision in the Engie case (Decision (E.U.) 2019/421). The case concerns the tax position of three companies involved in a domestic “hybrid” instrument structure and whether Luxembourg should have applied its domestic anti-abuse rule. The Commission found that Luxembourg granted unlawful State Aid to Engie. Luxembourg appealed this decision to the European Union General Court (cases T-525/18 and T-516/18, respectively). On May 12, 2021, the General Court of Justice of the E.U. upheld the Commission decision of June 2018, finding that Luxembourg granted unlawful State Aid to Engie. Engie and Luxembourg filed an appeal with the Court of Justice of the E.U. On December 5, 2023, the Court annulled both the judgment of the General Court and the Commission’s decision. It concluded the Commission did not establish that Luxembourg granted a selective tax advantage and was in breach of E.U. law.

On September 19, 2018, the Commission took a positive decision in the McDonald’s case, stating that Luxembourg did not grant McDonald’s a selective advantage

(Decision C (2018) 6076 final). The case concerned a mismatch in the context of U.S. branch.

On May 3, 2019, the Commission published its opening decision (Decision C (2019) 1615 final dated March 7, 2019) in the Huhtamaki case, which concerns A.T.A.'s issued by the L.T.A. to the Finnish packaging group in 2009, 2012, and 2013. These rulings concern a Luxembourg intragroup financing company funded with interest-free loans ("I.F.L.") granted by an Irish sister company. The A.T.A.'s allowed the Luxembourg company to impute a deduction for deemed interest expenses on the I.F.L. for M.B.T. and C.I.T. purposes. In the Commission's view, the allowance of a notional deduction constituted a selective advantage which deviated from Luxembourg's reference system (*i.e.*, its corporate income tax).

### **Claim and Tax Objections**

The deadline for filing a claim (*réclamation*) against a decision of the L.T.A. is three months from the notification of the assessment. For now, the regular objection deadline still applies.

After the decision of the L.T.A., a taxpayer can object to the decision in front of an administrative court. The deadline for filing an objection against a decision is three months. The deadline for filing an appeal of a judgment of the administrative tribunal is 40 days.

### **Exchange of Information**

Luxembourg and the United States concluded a Model 1 Intergovernmental Agreement ("I.G.A.") regarding the application of F.A.T.C.A. in Luxembourg on March 28, 2014. The I.G.A. was implemented in Luxembourg domestic law by a law dated July 24, 2015. Reporting Luxembourg financial institutions must give specified information on their U.S. account holders to the L.T.A., which in turn pass that information to the U.S. I.R.S.

Luxembourg has also implemented the O.E.C.D.'s common reporting standard ("C.R.S.") and the revised E.U. directive on administrative cooperation (2014/107/E.C.), which effectively implements the C.R.S. into E.U. law. Luxembourg financial institutions therefore must comply with additional due diligence rules for their account holders and the shareholders of investment entities. Further, additional reporting rules apply for Luxembourg financial institutions with financial accounts held by persons who are tax resident in an E.U. Member State or a country participating in the C.R.S.

On December 8, 2015, the E.U. Council adopted Directive 2015/2376/E.U. (the "E.O.I. Directive") amending Directive 2011/16/E.U. regarding the mandatory automatic exchange of information in the field of taxation. The E.O.I. Directive was implemented in Luxembourg by law on July 23, 2016, and was introduced as of January 1, 2017. It covers the mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements and is aimed at enhancing fiscal transparency between E.U. Member States and deterring aggressive tax planning and abusive tax practices.

The automatic exchange should include a defined set of basic information that will be sent to all Member States and the E.U. Commission (though the latter's access is limited). After the exchange of information takes place, an E.U. Member State may

request additional information if it believes the information is relevant to the application of its own tax rules. The information is covered by Form 777E, which serves to summarize the content, scope, and application of the A.T.A./A.P.A.

The automatic exchange covers A.T.A.'s/A.P.A.'s (i) issued, amended, or renewed after December 31, 2016 and (ii) issued less than five years prior to January 1, 2017. Only rulings involving cross-border transactions are covered by the E.O.I. Directive, and rulings concerning only natural persons are excluded.

Rulings and pricing arrangements issued after December 31, 2016, must be communicated within three months following the end of the calendar-year semester in which issued. Rulings and advance pricing arrangements issued between January 1, 2012, and December 31, 2013, which are still valid on January 1, 2014, and rulings and advance pricing arrangements issued between January 1, 2014, and December 31, 2016, (whether still valid or not) were reported before January 1, 2018. Rulings and advance pricing arrangements issued before April 1, 2016, concerning persons with a group-wide annual net turnover exceeding €40 million are not reported.

As a result of the implementation into the laws of the Member States of the E.U. Directive (E.U./2018/822) introducing mandatory disclosure rules (the “Mandatory Disclosure Directive”), advisers, other intermediaries, and taxpayers may be legally required to disclose information to E.U. Member States’ tax authorities on certain advice given and services rendered regarding cross-border tax planning arrangements that qualify as reportable cross-border arrangements. The domestic law relating to the Mandatory Disclosure Directive entered into force on January 1, 2021. In addition, each relevant taxpayer must annually disclose in a tax return how the arrangement was used.

On May 16, 2023, Luxembourg implemented the E.U. directive 2021/514 amending Directive 2011/16/E.U. on administrative cooperation in the field of taxation, which introduces new rules for the automatic exchange of information for digital platform operators and creates a legal framework for joint audit with other Member States.

### **Country-by-Country Reporting**

On December 13, 2016, the Luxembourg Parliament adopted a law on Country-by-Country Reporting (“C-b-C Reporting”), in accordance with E.U. Directive 2016/881 of May 25, 2016, requiring the implementation of a C-b-C Reporting obligation in Member States’ national legislation. The obligation to prepare a C-b-C Report applies to large multinational enterprise groups with total consolidated group revenue that exceeds €750 million during the previous fiscal year. Each Luxembourg tax resident entity that is the parent entity of a multinational group, or any other reporting entity defined in the draft law, must file a C-b-C Report with the L.T.A. In addition, the law introduced a secondary reporting mechanism whereby the reporting obligations are, under certain conditions, shifted from the parent company to a Luxembourg subsidiary or a permanent establishment. The deadline for the submission of C-b-C Reports is 12 months after the last day of the relevant fiscal year. In addition, each Luxembourg entity that is part of a multinational enterprise group must notify the L.T.A. on an annual basis of the identity of the entity that will be filing the C-b-C Report for the year concerned. The deadline for this notification is the last day of the fiscal year of the multinational enterprise group.

*“The domestic law relating to the Mandatory Disclosure Directive entered into force on January 1, 2021.”*



On July 21, 2023, a bill (Bill no. 8158) was adopted by the Luxembourg parliament. It takes effect in Luxembourg for accounting periods beginning on or after June 22, 2024.

## S.I.C.A.R.

The S.I.C.A.R. law provides a flexible and tax-favorable regime for any investments in risk-bearing capital. The purpose of this law is to facilitate private equity and venture capital investments within the E.U.

A 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 a *société en commandite simple* (“S.C.S.”) or *société en commandite spéciale* (“S.C.S.P.”). A S.I.C.A.R. is a regulated entity, though in a relatively light manner compared to certain other Luxembourg 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.”). It benefits from flexible legal rules regarding investment in private equity and venture capital.

In principle, a S.I.C.A.R. organized as a capital company is fully taxable for C.I.T. purposes. However, income realized in connection with its investments in risk-bearing securities is fully exempt from C.I.T. Other income, such as interest accrued on bank deposits, management fees, and the like, is normally taxed. In a cross-border situation, the L.T.A. take the position that a S.I.C.A.R. is entitled to the benefits of the Luxembourg tax treaties and the P.S.D. In addition, a S.I.C.A.R. is exempt from net worth tax (except for minimum net worth tax of €4,815) 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 the S.I.C.A.R. A S.I.C.A.R. is subject to the minimum tax rules, as described above in **Capital Duty**.

A S.I.C.A.R. organized as a limited partnership is not subject to C.I.T. due to its tax transparency. As a result, its profits will not be liable to Luxembourg income taxes at fund and the investor level, nor will its distributions give rise to withholding tax.

## S.I.F.

The S.I.F., introduced by the S.I.F. law in 2007, is a lightly-regulated fund reserved for well-informed investors which is subject to risk diversification. The S.I.F. is an income tax exempt entity. If structured as an F.C.P. or a partnership, it is fully tax transparent.

The S.I.F. is subject to a subscription tax of 0.01% of its net assets, with an exemption possible for certain money market and pension funds, or S.I.F.’s investing in other funds already subject to subscription tax.

## R.A.I.F.

The R.A.I.F. is an attractive regime created in July 2016. It allows for flexible establishment and operating rules: its setup does not require approval by the C.S.S.F., and it is also allowed certain structuring features which at present are only available

to regulated A.I.F.'s (e.g., umbrella structure, variable capital, specific tax regime). In addition, access to the marketing passport as per Directive 2011/61/E.U. on A.I.F. managers (the "A.I.F.M.D.") is available, and investors' protection is ensured by the full application of the A.I.F.M.D. regime at the manager's level.

R.A.I.F.'s are by default only subject at the fund entity level to an annual subscription tax levied at a rate of 0.01% of its net assets. Irrespective of the legal form chosen for an R.A.I.F., it will not be subject to C.I.T., municipal business tax, or net wealth tax, and distributions of profits by an R.A.I.F. will not give rise to a withholding tax.

As an alternative to the default tax regime, an R.A.I.F. may choose to be taxed according to the same tax rules as those applicable to S.I.C.A.R.'s, as described above in **S.I.C.A.R.**

## SECURITIZATION VEHICLES

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:

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.<sup>13</sup>

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

The S.V. 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 C.I.T. at the standard combined rate of 24.94%. However, the securitization vehicle is able to deduct from its taxable base all "commitments" owed to investors and creditors. A

<sup>13</sup> Article 1(1) of the law of March 22, 2004, on securitization.



commitment should be interpreted as including all payments declarations, or properly accrued amounts, either in the form of interest or dividends, made by the securitization vehicle to its investors and creditors. The taxable result of a securitization vehicle therefore is generally nil or close to) nil albeit that the interest deduction limitation rules referred to above in **Financial Costs** apply to interest payments made by a securitization vehicle and a securitization vehicle is subject to the minimum net worth tax described above in **General**. Securitization vehicles set up in the form of a partnership are generally considered transparent for C.I.T. and M.B.T. purposes.

Dividend distributions from a securitization vehicle are not subject to withholding tax as such distributions are treated as business expenses of the securitization vehicle. A S.O.P.A.R.F.I. receiving dividends from, or realizing gain on the sale of shares in, a securitization vehicle is not entitled to the participation exemption.

In a cross-border situation, the L.T.A. take the position that the securitization vehicle 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 P.S.D. Cross-border tax relief with respect to dividends received or distributed by a securitization vehicle depends on the analysis made by the other E.U. Member States and treaty countries.

Securitization vehicles are exempt from net worth tax other than minimum net worth tax.

## RECENT AND CURRENT DEVELOPMENTS

### Codification of the Practice of Redemption of Classes of Shares

On May 24, 2024, bill number 8388 (“Bill 8388”) was presented to the Luxembourg parliament introducing, amongst other things, provisions concerning the tax treatment of the repurchase and cancellation of a class of shares, which will codify a well-established practice in Luxembourg.

The provisions in Bill 8388 stipulate that the repurchase and cancellation of an entire class of shares is to be treated as a partial liquidation and therefore exempt from withholding tax. For the treatment to apply, the following conditions must be met:

- The redemption and cancellation should concern the entire class of shares.
- The cancellation should take place within six months from the repurchase.
- The share classes should be created at incorporation of the entity or on the occasion of a capital increase.
- Each class of shares should have different economic rights, such as preferred return, exclusive rights to profits for a certain period, or profits entitlement linked to the performance of the underlying asset (*i.e.*, tracking features).
- The criteria for determination of the repurchase price are determined or determinable on the basis of the articles of association (or another document referred to within the articles of association) and reflect the fair market value of the class of shares at the time of the repurchase.

*“Securitization vehicles are exempt from net worth tax other than minimum net worth tax.”*

In cases where a shareholder whose shares are being repurchased and cancelled is an individual who owns a substantial shareholding (10% or more) in the Luxembourg company, the company will have to disclose the information relevant for the identification of the individual shareholder in its tax return.

Once Bill 8388 is passed, the provisions will enter into force the day following its publication in the Luxembourg Official Journal.

### **Amendments to the Minimum Net Worth Tax Rules**

Bill 8388 further introduces amendments to the existing minimum net worth tax rules as explained in **iAnnual Net Worth Tax** above. The amendments follow from the decision of the Luxembourg Constitutional Court ruling that the current provisions are unconstitutional.<sup>14</sup>

Based on the proposed rules, the minimum net worth tax will be determined on the basis of a company's total balance sheet without any additional criteria. A company with a balance sheet total of up to €350,000 will be subject to a minimum net worth tax of €535, a company with a balance sheet total of more than €350,000 but less than €2,000,000 will be subject to minimum net worth tax of €1,605, and a company with a balance sheet total of more than €2,000,000 will be subject to minimum net worth tax of €4,815.

The provisions of Bill 8388 in respect to the minimum net worth tax will apply for the 2025 fiscal year and following years.

### **Possibility to Opt Out of the Participation Exemption**

Bill 8388 introduces amendments to Article 166 (1) of the I.T.A. and Article 115 (15) of the I.T.A. and provide for the possibility to opt out of the application of the participation exemption (described in **Participation Exemption** above) and the partial participation exemption (described in the **Partial Participation Exemption** above).

The possibility to opt out of the exemption would be possible for Luxembourg companies entitled to the (partial) participation exemption solely by application of the acquisition price criterion (€1,200,000 for dividends and liquidation proceeds and €6,000,000 for capital gains) and is not available for participations of 10% that do not meet the acquisition price criterion.

The option is to be exercised explicitly in a tax return for each fiscal year.

### **Pillar Two – Implementation in Luxembourg**

On December 14, 2022, E.U. Member States adopted E.U. Council Directive 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the E.U., known as the Pillar Two Directive.

On December 20, 2023, Luxembourg parliament adopted the law transposing the text of the E.U. Pillar Two Directive into domestic law. The law entered into force for fiscal years starting on or after December 31, 2023. The Income Inclusion Rule

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<sup>14</sup> *Supra* note 1, above.

("I.I.R.") and the Qualified Domestic Minimum Top-up Tax ("Q.D.M.T.T.") are effective for fiscal years starting on or after December 31, 2023. The Undertaxed Profits Rule ("U.T.P.R.") becomes effective for fiscal years starting on or after December 31, 2024. The I.I.R., Q.D.M.T.T. and U.T.P.R. are explained in more detail in Chapter 3 of this article, regarding B.E.P.S.



# SWITZERLAND

## Author

Fabienne Limacher  
Walder Wyss Ltd.  
Zürich, Switzerland

## GENERAL

In Switzerland, companies are generally taxed on the Federal, cantonal, and communal level. The cantonal and communal taxes, which are the functional equivalent of state taxes in the U.S., can be imposed at a rate that exceeds the Swiss Federal tax rate.

All companies are subject to an annual capital tax on the net equity of the company, consisting of nominal share capital, capital contribution reserves, reserves, and retained earnings on the cantonal and municipal level. Some cantons allow companies to reduce the tax base of the capital tax. Specifically, a reduction of equity is possible to some extent relating to participations, patents, and similar rights and loans to group companies. For example, in the canton of Zürich, the ordinary capital tax takes into account only 10% of the abovementioned assets. Moreover, in some cantons, it is possible to credit capital tax against corporate income taxes.

## TAXATION OF COMPANIES IN SWITZERLAND

### Corporation Income Tax

All companies are subject to corporate income tax levied on the Federal, cantonal, and municipal level. Corporate income and capital taxes paid to the Federal government, as well as to the cantons and the municipalities, are deductible from taxable income. Therefore, the effective income tax rate in Switzerland is lower than the statutory income tax rate.

### Corporate Income Tax Rates

The Federal corporate income tax rate is 8.5%, but because taxes are deductible, the effective rate is roughly 7.8%. The cantonal and communal corporate income tax rates depend on the company's domicile. The combined effective ordinary income tax rates (which include Federal, cantonal, and municipal taxes) vary significantly among the cantons and communities, ranging from 11.22% to 22.79%. Some examples of the currently applicable combined effective tax rates are listed below:

- 12.15% in the city of Lucerne
- 12.74% in Sarnen (canton of Obwalden)
- 11.97% in Stans (canton of Nidwalden)
- 11.82% in Zug
- 19.65% in Zürich

The author acknowledges the assistance of Daniela Hottiger, of Walder Wyss AG in Zürich, in the preparation of this chapter of the article.

- 14.00% in Geneva
- 13.04% in Basel
- 21.04% in Bern

### *Taxable Income and Participation Relief*

As a general rule, all income is taxable. However, income attributable to foreign enterprises, foreign permanent establishments, or real estate located abroad is exempt from taxation in Switzerland. Swiss tax law grants participation relief for (i) dividend income and (ii) capital gains on qualifying participations in Swiss or foreign companies held for at least one year.

Participation relief with regard to dividends will be granted for dividends deriving from participations representing at least 10% of the nominal share capital or reserves, or to participations with a fair market value of at least CHF 1 million. With regard to capital gains, participation relief will apply only if a participation of at least 10% is sold, *i.e.*, in contrast to dividend income, the threshold of CHF 1 million does not apply to capital gains.

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, and the total net profit. As financing costs are considered for the calculation, high interest costs will lead to a dilution of the relevant participation relief (*i.e.*, no full exemption of dividends and capital gains).

### *Tax Relief Measures*

In response to increasing international pressure, tax privileges such as the special regime for holding companies were abolished effective January 1, 2020. The privileged tax treatment of finance branches, mixed, domiciliary, principal, and holding companies have been replaced by other measures compliant O.E.C.D. rules such as the I.P. box, the R&D super deduction, and the notional interest deduction. In addition, many cantons have reduced their corporate income and capital tax rates significantly as part of the reform, with the aim of retaining their attractive positions for locating a business presence.

The Swiss patent box regime provides for a privileged taxation of income from patents and similar intellectual property rights on the cantonal and municipal level. Depending on the canton, a broad tax exemption applies to between 40% to 90% of the qualifying I.P. income. The O.E.C.D.'s nexus approach for I.P. regimes will be applied, *i.e.*, the R&D expenses need to be incurred through operations carried out by the patent box company itself. The patent box regime is not applicable on the Federal level.

Some cantons allow for a so-called super deduction of up to 150% for Swiss-performed R&D expenses, applicable to the tax base of the cantonal and municipal taxes.

The canton of Zürich furthermore grants an interest deduction on equity, which benefits companies that are mainly equity-financed. This is the so-called notional interest deduction, or "N.I.D."

*“Switzerland has abolished the privileged tax status for holding companies”*

The sum of the combined benefits of the patent box treatment, R&D super deduction, and N.I.D. may not exceed 70% of the overall taxable income on the cantonal and municipal level for the relevant tax period.

As mentioned above, Switzerland has abolished the privileged tax status for holding companies. However, for pure holding companies, *i.e.*, companies whose entire income is generated by qualifying dividends or capital gains, the abolition of the holding company privilege has not generally led to higher overall taxation. Thanks to the participation relief discussed above, such companies are virtually exempt from Swiss income tax. In fact, taxes might even be lower due to the N.I.D., and due to a lower capital tax on certain assets as described above.

#### 15% Minimum Income Tax (Implementation of Pillar Two of the O.E.C.D. B.E.P.S. Project)

By means of a constitutional amendment, Switzerland implemented a minimum tax rate of 15% for large multinational companies as agreed upon by the O.E.C.D. and G20 member states. Since January 1, 2024, the minimum tax rate of 15% has been in force based on a temporary ordinance. The respective tax law will be enacted subsequently in the usual manner.

#### **Capital Tax**

In addition to corporate income tax, an annual equity capital tax is levied on the cantonal and municipal level. As previously mentioned, there is no capital tax on the Federal level. The tax rate depends on the canton and lies in the range of one per thousandth (capital  $\times$  0.001) to 0.5% of the net equity (nominal share capital, capital contribution reserves, reserves, and retained earnings) of the company.

For example, the capital tax rate in the cantons of Obwalden and Uri amounts to only one per thousandth (capital  $\times$  0.001%) of the company's total net equity measured at book value. Further examples are as follows:

- 0.012% in Schwyz
- 0.005% in Schaffhausen
- 0.01% in Nidwalden
- 0.07% in Zug
- 0.18% in Lucerne
- 0.171% in Zürich
- 0.401% in Geneva
- 0.1% in Basel

As previously mentioned, some cantons allow the companies to reduce the tax base of the capital tax. Specifically, a reduction of equity relating to participations, patents, and similar rights, and loans to group companies is possible to some extent. Also as previously mentioned, the canton of Zürich considers 10% of the value of assets cantons such as Schwyz and Geneva allow corporate income taxes to be credited against capital tax. However, as the credit is not refundable, no benefit will be obtained if no corporate income tax is due.



## **Stamp Duty**

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 one-time capital duty at a rate of 1%. Issuances up to CHF 1 million are exempt.

Relief is available for shares issued pursuant to a corporate restructuring, a share-for-share acquisition, or an 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 or 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 hence benefit from the stamp duty exemption.

## **Value Added Tax**

A Swiss company may be subject to V.A.T. at the present standard rate of 8.1% if it provides services and receives management fees from affiliates or other service income exceeding CHF 100,000 per year. A reduced rate of 2.6% applies to some goods such as medicine, newspapers, books, and food. Accommodation services such as hotels are taxed at a special rate of 3.8%.

Taxable transactions subject to V.A.T. include (i) the supply of goods or services for consideration within the Swiss territory, (ii) the purchase of services from abroad (reverse charge), and (iii) the importation of goods (import V.A.T.).

A company may recover V.A.T. paid on costs if it is registered for V.A.T. with the Swiss Federal Tax Administration and such costs are attributable to taxable supplies, including zero-rated supplies.

## **Securities Transfer Tax**

The transfer of taxable securities will be subject to securities transfer tax if the 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. Swiss securities dealers include banks and bank-like financial institutions as defined by Swiss banking laws, investment fund managers, and Swiss companies holding securities with a book value exceeding CHF 10 million. The rate of securities transfer tax is 0.15% of the sale price for Swiss securities and 0.3% for foreign securities. This amounts to 0.075% for Swiss securities and 0.15% for foreign securities and is applicable to each party that is not itself exempt or eligible for a specific exemption.

## **Swiss Withholding Tax**

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, regardless of the status and nature of the investor. It applies equally to private and institutional investors and to domestic and foreign investors. The repayment of nominal share capital and capital contribution reserves, however, is not subject to Swiss withholding tax. Restrictions apply to Swiss-listed companies in the sense that they may only pay out withholding tax-free dividends from their capital contribution reserves if they pay out a dividend from their taxable distributable reserves in the same amount (the so-called “50/50 rule”). As a general rule, 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 10% interest in its Swiss subsidiary.

A nonresident company may also be entitled to a full or partial refund of Swiss withholding tax under an applicable double tax treaty or, in the event of an E.U. parent company, under the agreement between Switzerland and the E.U. on the automatic exchange of information (“A.E.O.I.”) in tax matters. For example, dividends paid to any E.U. parent company may benefit from the notification procedure if the parent directly holds at least 10% of the Swiss subsidiary (or a lesser percentage, as provided by an applicable tax treaty). However, the distributing 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 certain other countries, dividend distributions will be subject to a reduced Swiss withholding tax (e.g., 5% for the U.S.). The notification procedure will be available if the requirements of the relevant 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 the source has been obtained prior to any dividend distribution.

### **Tax Credit for Foreign Withholding Taxes**

For nonrefundable foreign withholding taxes, Switzerland provides a limited tax credit (“*Pauschale Steueranrechnung*”). It is granted only for income arising in a foreign State with which Switzerland has concluded a double tax treaty. Switzerland allows relief in the form of a foreign tax credit for the unrecoverable portion of foreign withholding taxes.

The tax credit is limited to the Federal, cantonal and municipal tax payable in a relevant tax period unless steps are taken in advance to counteract this limitation. No tax credit will be granted on income derived from qualifying participations benefitting from participation relief.

### **Real Estate Capital Gains and Transfer Tax**

Real estate capital gains taxes and transfer taxes may be triggered on a cantonal and communal level upon the sale of real estate property situated in Switzerland or a real estate company.



# ASPECTS OF SWISS INTERNATIONAL TAX LAW

## Swiss Tax Treaty Network

Switzerland has income tax treaties with over 100 jurisdictions, including all old and new E.U. Member States and the majority of Switzerland's important trading partners. Most of the Swiss double taxation treaties follow the O.E.C.D. Model Tax Convention on Income and on Capital. It has also entered into several limited treaties regarding sea and air enterprises.

|                        |               |                   |                          |
|------------------------|---------------|-------------------|--------------------------|
| Albania*               | Egypt         | Lebanon           | Slovakia                 |
| Algeria                | Estonia*      | Liechtenstein*    | Slovenia**               |
| Anguilla               | Ethiopia*     | Lithuania*        | South Africa**           |
| Antigua & Barbuda      | Faroe Islands | Luxembourg*       | South Korea*             |
| Argentina**            | Finland       | Malawi            | Spain*                   |
| Armenia *              | France*       | Malaysia          | Sri Lanka                |
| Australia*             | Gambia        | Malta*            | St. Kitts & Nevis        |
| Austria**              | Georgia       | Mexico*           | St. Lucia                |
| Azerbaijan             | Germany       | Moldova           | St. Vincent & Grenadines |
| Bangladesh             | Ghana*        | Mongolia          | Sweden*                  |
| Bahrain*               | Greece        | Montenegro        | Taiwan*                  |
| Barbados               | Grenada       | Montserrat        | Tajikistan*              |
| Belarus                | Hong Kong*    | Morocco*          | Thailand                 |
| Belgium*               | Hungary*      | Netherlands*      | Togo                     |
| Belize                 | Iceland*      | New Zealand*      | Trinidad & Tobago        |
| Brazil*                | India*        | North Macedonia** | Tunisia                  |
| Bulgaria*              | Indonesia     | Norway*           | Turkey**                 |
| Burundi                | Iran**        | Oman*             | Turkmenistan             |
| British Virgin Islands | Ireland*      | Pakistan*         | Ukraine*                 |
| Canada                 | Israel        | Peru*             | United Arab Emirates*    |
| Chile*                 | Italy*        | Philippines       | United Kingdom*          |
| China*                 | Ivory Coast   | Poland            | United States*           |
| Colombia*              | Jamaica       | Portugal*         | Uruguay                  |
| Congo (Republic)       | Japan*        | Qatar*            | Uzbekistan               |
| Croatia                | Kazakhstan    | Romania           | Venezuela                |
| Cyprus*                | Kenya         | Russia*           | Vietnam                  |
| Czech Republic*        | Kosovo*       | Rwanda            | Zambia*                  |
| Denmark                | Kuwait**      | Saudi Arabia*     |                          |
| Dominica               | Kyrgyzstan    | Serbia**          |                          |
| Ecuador*               | Latvia*       | Singapore         |                          |

\* Treaty that includes a treaty abuse clause currently in force.

\*\* Treaty that includes a treaty abuse clause not yet in force.

New treaties with Angola, Jordan, and Zimbabwe have been signed, but are either not yet ratified or not yet in force.

Negotiations with other countries have taken place or are still under way. Such countries include Bosnia and Herzegovina, Cameroon, Costa Rica, Libya, Nigeria, Senegal, and Syria.

Further discussions are under way regarding the existing treaties with Armenia, Canada, Germany, Hong Kong, Israel, Kenya, Qatar, Russia, Rwanda, Singapore, Sri Lanka, South Africa, U.A.E., and the U.S.A.

### **Multilateral Instrument**

Switzerland has signed the Multilateral Instrument (“M.L.I.”) to implement Tax Treaty-Related Measures to prevent Base Erosion and Profit Shifting. The Federal government announced that it will implement the minimum standards within the framework of the M.L.I. and by means of the bilateral negotiation of double tax agreements. The Swiss parliament approved the ratification of the M.L.I. on March 22, 2019 and the ratification bill is deposited with the O.E.C.D. It entered into force on December 1, 2019. It should be noted that the impact of the M.L.I. on Switzerland’s treaty network is limited, as Switzerland designated only 12 (out of over 100) treaties that will be amended directly through the M.L.I. Thus, the agreement is binding in relation to the following jurisdictions (as of March 13, 2023):

|              |                |
|--------------|----------------|
| Argentina    | Austria        |
| Chile        | Czech Republic |
| Iceland      | Italy          |
| Lithuania    | Luxembourg     |
| Mexico       | Portugal       |
| South Africa | Turkey         |

However, Switzerland is currently implementing the B.E.P.S. minimum standards by renegotiating its double tax treaties on a bilateral basis to make sure that the regular parliamentary approval process will be followed. To date, Switzerland has incorporated the B.E.P.S. minimum standard in over 20 double tax treaties and it is currently conducting bilateral discussions with other jurisdictions to implement the B.E.P.S. minimum standard.

Materially, the new treaty provisions resulting from the B.E.P.S. minimum standards accomplish the following:

- They modify the description of the treaty’s purpose in the preamble.
- They include a principle purpose test providing that a benefit under a tax treaty will not be granted if obtaining that benefit was one of the principle purposes of an arrangement or transaction.
- They adjust the provisions governing dispute resolution within the framework of mutual agreement procedures. In keeping with its treaty policy, Switzerland opts for the inclusion of the mandatory and binding arbitration clause provided for in the M.L.I.

### **National Treaty Abuse Rules**

Since 1962, Swiss internal law has contained measures designed to prevent the misuse of double tax treaties. The original legislation and the subsequent circular

letters issued by the Swiss Federal Tax Administration only applied to payments made to a Swiss company in the absence of a specific treaty provision (*i.e.*, in inbound situations) and were designed to prevent the abuse of Swiss intermediary companies.

Following the signing of the M.L.I., which contains a wide-reaching “principle purpose test,” the original legislation was partially repealed in 2017 and transformed into an ordinance. As of January 1, 2022, this ordinance was completely repealed and replaced by the Federal Law on the Implementation of International Agreements in the Tax Field and its related ordinance. This act is currently in force now and also stipulates how mutual agreement procedures are to be carried out on the national level, provided the applicable agreement does not contain any deviating provisions. Moreover, it contains key points for providing withholding tax relief based on international agreements, as well as criminal provisions in connection with relief from withholding taxes on investment income.

## ADDITIONAL TAX-RELATED ISSUES

### **U.S. Check-the-Box Rules**

In Switzerland, most companies are incorporated either as an *Aktiengesellschaft* or as a GmbH. Since the Swiss *Aktiengesellschaft* qualifies as a *per se* corporation for 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 as no limitations are imposed 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 (i) the cantonal tax authorities with regard to cantonal, communal, and Federal income taxes; and (ii) the Federal tax authorities with regard 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 the subject of an advance ruling request by a taxpayer. Swiss rulings that have an effect in a member jurisdiction of the E.U. are reported to the tax authorities in that jurisdiction via the automatic exchange of information.

### **Swiss Debt-Equity Rules**

In 1997, the Swiss Federal tax administration issued the detailed Circular Letter no. 6 regarding the debt-to-equity ratios of Swiss companies. According to this circular letter, the minimum equity of a company is inversely related to the maximum indebtedness allowed to fund the assets of the company. Generally, the minimum capital will range between 15% and 30% of the book value of the assets. If a company is debt-financed by related parties in excess of the maximum permissible percentage (*e.g.*, 70% for participations), the company will be deemed to be thinly capitalized for Swiss tax purposes. As a consequence, the excess debt will be considered hidden equity for capital tax purposes. Interest payments on this debt generally are not tax-deductible and will be requalified as deemed dividend distributions that are subject to Swiss withholding tax.

*“In Switzerland, most companies are incorporated either as an Aktiengesellschaft or as a GmbH.”*



Nonetheless, a court decision in 2015 approved interest expense deductions for higher amounts of interest where the taxpayer proves it meets the arm's length standard.

Furthermore, special guidelines apply concerning the minimum and maximum interest on loans granted to or from shareholders or related parties. With regard to the arm's length character of the interest rate, the Swiss Federal Tax Administration annually publishes safe harbor interest rates in its circular letters.

If the interest rate on loans applied by a company is below the permissible maximum rate, interest payments on hidden equity will be tax-deductible to the extent of the differential amount between interest payments made and maximum interest payments allowed.

### **Step-up Upon Migration to Switzerland or Company Status Change**

When a foreign company immigrates to Switzerland or a change occurs in a Swiss company's tax status, such as might occur from the termination of a special tax status, a tax-free step-up to fair market value will be allowed with regard to the basis of the assets reported on the company's tax balance sheet. This will result in an increase in the allowance for depreciation for Federal and cantonal tax purposes in Switzerland.

## **USE OF SWISS HOLDING COMPANIES**

Prior to the abolition of the complete income tax exemption on the cantonal and communal levels that became effective on January 1, 2020, Swiss holding companies were not permitted to conduct business in Switzerland in order to retain privileged tax status. These restrictions have now been lifted, enhancing the value 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 after a one-year holding period of the participation.
- Switzerland does not levy withholding tax on outbound royalties and outbound interest payments, with the exception of interest paid on bonds.
- Switzerland does not have any C.F.C. legislation.

In light of recent initiatives focused on combatting base erosion and profit shifting and other ongoing changes in worldwide taxation principles, it is advisable for a Swiss holding company to have substance in Switzerland in the form of office space that is actively used by competent personnel.

## NETHERLANDS

### Author

Sjoerd Stokmans  
Van Doorne  
Amsterdam, Netherlands

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. Historically, the main benefits of the Dutch holding company have been as follows:

- 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)
- The Dutch tax ruling practice
- The transparency of its holding regime

The foregoing benefits were supplemented by bilateral investment treaties that provide protection for investments of Dutch-resident entities when jurisdictions enact measures targeting foreign investors.

However, the Dutch tax climate has changed in the last few years as a consequence of the discussions held within the E.U. and the O.E.C.D. New rules and regulations have been introduced to ensure that the Dutch tax system and its tax treaties cannot be misused by investors established in or using conduit companies established in low-tax jurisdictions.

The author acknowledges the assistance of Nienke Petri and Cézanne Alsemgeest, also of Van Doorne, in updating this chapter of the article.

## CORPORATION INCOME TAX – GENERAL

In principle, all income of a holding company will be subject to Dutch corporation income tax at the rate of 25.8% for profits exceeding €200,000. Profits up to €200,000 (the lower bracket) are taxed at a rate of 19.0%.

## PARTICIPATION EXEMPTION

### In General

Under the participation exemption set forth in Article 13 of the Corporation 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 corporation income tax, while capital losses are deductible only under special circumstances, as discussed later in this chapter. No minimum holding period is required, although in a short term buy-and-sell transaction, part of the tax-exempt capital gains realized may be characterized as a taxable service fee. The participation exemption applies only if the interest held by the Dutch-resident taxpayer qualifies as a participation (“*deelneming*”). A participation exists if one of the following criteria is met:

- The Dutch taxpayer holds at least 5% of the nominal paid-up capital of a company with capital divided into shares.
- The Dutch taxpayer holds an interest in an “open” limited partnership that gives entitlement to at least 5% of the profits realized by the open limited partnership.
- The Dutch taxpayer holds at least 5% of the participating certificates of a fund for joint account.
- The Dutch taxpayer is a member of a cooperative.
- The Dutch taxpayer holds an interest that entitles it to at least 5% of the profits realized by a reverse hybrid entity. Such reverse hybrid entity qualifies as a participation if the entity is formed under Dutch law or established in the Netherlands, and at least 50% of the voting rights, capital interests, or profit rights in that entity are held directly or indirectly by one or more entities established in a state that considers the reverse hybrid entity to be nontransparent while the Netherlands would ordinarily consider it to be transparent. Where the above conditions are met, the interest in the reverse hybrid is considered a participation for a 5% corporate shareholder. In the absence of an applicable exemption, the underlying entity becomes subject to Dutch corporate income tax and dividend withholding tax or conditional withholding tax.
- The Dutch taxpayer 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 based on 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 granted to that subsidiary or a profit-sharing right in that subsidiary will also qualify as a participation. This is discussed below in **Hybrid Loans and Profit Rights**. Similarly, if a Dutch taxpayer (i) holds less than 5% of the shares in a company, (ii) granted a hybrid loan to a company, or (iii) 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 drag along rule. Note that the term “related” is statutorily defined and refers to share ownership of at least one-third of the shares of the company. This is discussed below in **Base Erosion**.

Subject to advance confirmation from the Dutch tax authorities, the participation exemption will apply to gains and losses on financial instruments entered into by the Dutch taxpayer in order to hedge its currency risk with respect to exempt participations.

The participation exemption does not apply to participations that are held merely as passive investments (the “Motive Test”). However, if a participation in another company does not pass the Motive Test, the participation exemption will nevertheless be applicable if (i) the other company is subject to a “realistic levy” according to Dutch tax standards (the “Subject-to-Tax Test”) or (ii) not more than 50% of the assets of the other company consist, directly or indirectly, 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 underlying company is in line with the business of the shareholder. Also, a participation held by a Dutch parent holding company that conducts active management functions 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 – based on 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.

In comparison, the Motive Test is not met if the predominant function of the participation is to act as a group finance company or if more than half of the consolidated assets of the underlying company consist of various shareholdings, each of less than 5%.

## **Subject-to-Tax Test**

The Subject-to-Tax Test will be met if the domestic tax system of the jurisdiction of tax residence of the underlying company results in a realistic levy according to Dutch tax standards. This is generally the case if the underlying company 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 not more than 50% of the assets of the underlying company usually do not consist, directly or indirectly, of low-taxed, free passive assets. For this purpose, the assets must be considered at fair market value. The term “usually” implies that the participation exemption remains applicable if more than 50% of the assets of the participation consist of low-taxed, free passive assets for a short period of time. An example would be where a subsidiary sold its business and holds investment-grade securities until a new business is acquired.

Assets qualify as free passive assets in any of the following circumstances:

- The assets are passive assets that are not necessary for the business activities of the holder. Interest-bearing bank accounts, loan receivables, and passive investments such as bonds and shares, could be considered 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 zero-taxed investment institution.

- The assets are intercompany 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.
- The assets are leased to a group company, unless they are used by an active group leasing company or are at least 90% financed 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 allocated *pro rata* to the participation. Interests below 5% are in any event deemed to be passive assets. Finally, if less than 30% of the assets held by a company consist 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 qualify as “bad assets” only if they 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. A similar approach to the Subject-to-Tax Test applies for this purpose.

### **Earn-Out and Balance Guarantee Arrangements**

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

### **Expiring Participation**

If a qualifying participation falls below the 5% threshold due to 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 participation 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.

If a loan qualifies as a hybrid loan, the loan will be regarded as capital for corporation income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporation income tax purposes and, in principle, will be subject to a 15% dividend withholding tax.<sup>1</sup> On the other hand, the interest and principal received on a hybrid loan will be exempt from Dutch corporation income tax for the recipient and exempt from Dutch dividend withholding tax for the payer when the lender is a Dutch resident that owns a qualifying participation in the borrower or if the borrower qualifies as a related entity of the lender. See **In General** under **Participation Exemption**.

The Anti-Tax Avoidance Directive within the E.U. restricts the benefits of the Parent-Subsidiary Directive (“P.S.D.”) where the participation exemption results in double nontaxation. The participation exemption is not applicable to payments or other forms of remuneration derived from a participation to the extent these payments can be deducted legally or *de facto*, directly or indirectly, from the tax base of the company making the payment. This may be the case for certain hybrid financial instruments, typically hybrid loan receivables on participations held by Dutch parent companies. The anti-hybrid-instrument legislation has worldwide application and is not restricted to E.U. subsidiaries. Moreover, it is not limited to hybrid loans. Consequently, deductible dividend instruments, such as preferred shares and income received in lieu of payments may be covered by the legislation.

## **Partitioning Reserve**

If a taxpayer holds an interest in a company that undergoes a change in treatment (a “transition”) regarding application of the participation exemption, the taxpayer should consider establishing a partitioning reserve with regard to the shares held. The purpose of this reserve is to determine the taxable or exempt amount of gains or losses, in order to avoid double taxation upon a realization of a gain or loss originating 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 must be adjusted from book value to fair market value. The result of the revaluation is included in the partitioning reserve. If the transition is from taxable status to exempt status, a taxable partitioning reserve (“T.P.R.”) is formed. If the transition is from exempt status to taxable status, an exempt partitioning reserve is formed (“E.P.R.”). This E.P.R. or T.P.R. will be released upon realization at the time a dividend distribution is received or capital gain is realized.

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<sup>1</sup> For further explanation regarding dividend withholding tax, see **Minimum Tax Rate Act 2024**.

## OTHER ASPECTS

### Costs and Expenses

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

### Application of the at Arm's Length Principle

Pursuant to Article 8bb of the C.I.T.A., the application of the arm's length principle is denied if it leads to a reduction of the taxable profit in the Netherlands. To illustrate the application of the provision, assume a Dutch borrower claims a deduction for arm's length interest on a loan even though no interest is paid. The deduction is denied to the extent that the creditor in another country does not include a corresponding amount of income in its tax base or includes a lesser amount than the deduction claimed in the Netherlands.

### Base Erosion

Limitations apply to interest deductions arising from transactions that could be considered to result in base erosion for Dutch tax purposes. Pursuant to Article 10a of the C.I.T.A., interest paid on borrowings 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 related 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 loans to pay a dividend, to make an acquisition, or to make a contribution to capital. The base erosion provisions contain an exception under which an interest deduction will be granted if the taxpayer can demonstrate either of the following:

- Both the granting of the loan and the business transaction are based on sound business reasons.
- 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%.

*“ . . . the application of the arm's length principle is denied if it leads to a reduction of the taxable profit in the Netherlands.”*

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

- 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.
- The taxpayer and the other entity are part of the same fiscal unit for Dutch corporation income tax purposes.
- The taxpayer is part of a cooperating group of companies holding a total combined interest of at least one-third of the capital in the other entity.

### **Earnings Stripping**

As of January 1, 2019, the Anti-Tax Avoidance Directive (“A.T.A.D. 1”) was implemented in Dutch law through the introduction of Article 15b of the C.I.T.A. As a consequence, interest deductions will be limited whichever of the following two amounts is greater:

- 20% of the company’s earnings before interest, taxes, depreciation and amortization (“E.B.I.T.D.A.”)
- €1 million, instead of the €3 million limit allowed by A.T.A.D. 1

The Netherlands did not implement a group ratio escape rule. Moreover, Article 15b of the C.I.T.A. does not provide an exemption for financial businesses and stand-alone entities.

On April 28, 2023, the Dutch government announced that it plans to amend the earnings stripping rule for Dutch real estate entities to exclude them from the €1 million threshold as of January 1, 2025. This was confirmed in the Spring Memorandum (*Voorjaarsnota*) 2024. The proposed amendment specifically references real estate entities, *e.g.*, companies that lease properties to third parties. An exact definition of a “real estate entity” has not yet been provided. The details of the measure’s implementation are to be included in the Tax Plan 2025.

### **Hybrid Mismatches**

As of January 1, 2020, the amended Anti-Tax Avoidance Directive (“A.T.A.D. 2”) was implemented in Dutch law through the introduction of Article 12aa through 12ag of the C.I.T.A. Hybrid mismatches may occur in situations where countries use different qualifications for entities, financial instruments or permanent establishments.

The purpose of A.T.A.D. 2 is to eliminate the consequences of hybrid mismatches in affiliated relationships. The following anti-abuse rules apply:

- Payments made on a hybrid financial instrument will not be deductible in the event the corresponding income is not included in taxable income of the recipient within a reasonable period of time because of the hybrid nature of the instrument.



- Payments made to a hybrid entity will not be deductible to the extent they will not be taxed in the country where the hybrid entity is incorporated or established because of the hybrid nature of the entity.
- Payments made by a hybrid entity will not be deductible in the event the corresponding income is not included in taxable income of the recipient because of the hybrid nature of the payor.
- Payments made to an entity with one or more permanent establishments will not be deductible in the event the corresponding income is not included in taxable income because of a difference the way the payments are allocated between head office and its permanent establishment or between two or more permanent establishments.
- Payments made to a disregarded permanent establishment will not be deductible to the extent they are not included in taxable income of the permanent establishment.
- Payments made will not be deductible to the extent they lead to a double deduction.

Article 12ab of the C.I.T.A. further stipulates that a payment received by a Dutch taxable entity will be included in taxable income of that entity, if (i) the payment would be exempt from Dutch corporation income tax or not be recognized as income because of a hybrid mismatch and (ii) the payment would be deductible for the payer.

Finally, payments made by a Dutch entity to a foreign non-hybrid entity on a non-hybrid financial instrument will not be deductible if the foreign entity uses the proceeds to finance payments that would not be deductible if made directly by the Dutch entity on the basis of above rules.

The Dutch taxpayer must retain information in its permanent tax records showing that the A.T.A.D. 2 provisions are or are not applicable. In absence of documentation, it will be presumed that the hybrid mismatch rules will apply. This implies that the burden of proof shifts to the taxpayer.

### **Controlled Foreign Corporations**

Article 13ab of the C.I.T.A. provides for the immediate taxation of passive income, net of related expenses, generated by a direct or indirect foreign subsidiary established in a jurisdiction that levies a profit tax at a rate of less than 9%,<sup>2</sup> or is included on the E.U. list of noncooperative jurisdictions.<sup>3</sup>

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<sup>2</sup> Included in the list of low-tax countries as of January 1, 2024, are Anguilla, the Bahamas, Bahrain, Barbados, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Turkmenistan, Turks & Caicos Islands, and Vanuatu. This list is updated annually based on an assessment as of October 1 of the preceding tax year.

<sup>3</sup> The E.U. list of noncooperative jurisdictions for tax purposes adopted by the Council on February 20, 2024 is composed of American Samoa, Anguilla, Antigua & Barbuda, the Bahamas, Belize, Fiji, Guam, Palau, Panama, Russian Federation, Samoa, Seychelles, Trinidad & Tobago, Turks & Caicos Islands, the U.S. Virgin Islands, and Vanuatu. The list becomes official upon publication in the Official Journal.

The controlled foreign corporation (“C.F.C.”) rule is applicable to the foreign subsidiary in the above fact pattern, provided the Dutch holding company holds directly or indirectly an interest (i) representing more than 50% of the shares or the voting rights of the foreign subsidiary or (ii) that entitles the Dutch holding company to more than 50% of foreign entity’s profits, either directly or indirectly.

Passive income is defined as interest, royalties, dividends, and capital gains derived from shares, benefits derived from financial lease activities, benefits derived from insurance activities, banking activities or other financial activities, and benefits derived from certain invoicing activities.

Immediate taxation on the basis of Article 13ab of the C.I.T.A. will not be imposed if (i) income other than passive income represents 70% or more of the income of the foreign entity or (ii) the foreign entity is incorporated or established for valid business reasons that reflect the economic reality. Article 13ab of the C.I.T.A. does not apply if the passive income is repatriated from the C.F.C. to the direct or indirect Dutch holding company.

### **Innovation Box**

In order to stimulate research and development activities by Dutch taxpayers, self-developed registered patents and certain other assets for which a research and development statement has been requested, costs related to R&D activities may be expensed in the year incurred. In addition, R&D Assets may be placed in an Innovation Box as provided in articles 12b through 12bg C.I.T.A. Pursuant to the Innovation Box regime, a 9% 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 resulting 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 an R&D statement has been requested. The 9% effective tax rate will apply only to qualifying income. Trademarks are specifically excluded from this beneficial regime. The non-qualifying income will continue to be subject to tax at the statutory rates in effect for the year.

The Innovation Box regime applies to income received from related and unrelated parties. However, 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 9%. The threshold is made up of the development costs of the intangible asset earmarked for the Innovation Box. For this reason, the qualifying earnings must exceed the threshold before the effective tax rate of 9% can apply. The decision to use the Innovation Box should be made when the corporation income tax return is filed.

Following the outcome of the O.E.C.D.’s efforts to combat base erosion and profit shifting (the “B.E.P.S. Project”), minimum requirements for the application of so-called preferential I.P. regimes have been established by the O.E.C.D. Consequently, the “nexus approach” has been introduced to the Dutch Innovation Box regime in order to identify and quantify income attributable to the innovation and eligible for the reduced rate of tax.

To be eligible for the reduced rate, all technical innovations must be developed as part of an “approved project,” which is an R&D project that qualifies for the Dutch

*“Finally, grandfathering rules apply up to July 1, 2021, for innovations that were produced before June 30, 2016, and that were already benefiting from the Innovation Box at that time.”*

R&D subsidy, known as “W.B.S.O.” For companies that are members of a larger group having (i) a global turnover of at least €50 million annually or (ii) income generated by technical innovations of at least €7.5 million per year, technical innovations must (a) be protected by a patent or plant breeders’ rights,<sup>4</sup> or (b) qualify as software.

Finally, grandfathering rules apply up to July 1, 2021, for innovations that were produced before June 30, 2016, and that were already benefiting from the Innovation Box at that time.

### **Loss Compensation**

As of January 1, 2022, the annual benefit for losses incurred during or after 2013 is limited to 50% of the taxable profit in the carryover year, to the extent such profit exceeds a threshold of €1 million. This applies to both carryback and carry forward of losses. The carryback period for losses is one year. The carryforward period is indefinite.

### **Exemption from Debt Relief Income Tax**

Debt relief usually takes place as part of a (debt) restructuring. To the extent that such relief is at arm’s length, this in principle results in taxable income for the debtor. However, the Dutch C.I.T.A. has a scheme under which the debtor can – under certain conditions – benefit from a tax exemption on the profit resulting from the debt relief. The conditions for applying the so-called exemption from debt relief income tax are as follows:

- i. The debt relief is at arm’s length, meaning that the creditor acts in its position as creditor (not as, for example, a shareholder).
- ii. The creditor shows that it has legally waived its rights.
- iii. The rights concerned must be rights that cannot be achieved, meaning that the debtor is unable and presumably will remain unable to meet its obligations.
- iv. The waiver income is only exempt to the extent that it exceeds available carryover losses.

As discussed in **Loss Compensation**, only 50% of carryover losses are available to offset profits. This rule leads to obstacles in achieving restarts of loss-making entities where the debt relief income and carry-over losses exceed €1 million, because these entities – despite the debt relief income tax exemption – are faced with C.I.T. on the forgiveness of debt income. In the Spring Memorandum (*Voorjaarsnota*) 2024, the state secretary announced that the adjustment of the exemption from debt relief income tax is to be included in Tax Plan 2025. The purpose of the adjustment is to remove the obstacles created under existing law.

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<sup>4</sup> Plant breeder’s rights are rights granted to the breeder of a new variety of plant that give the breeder exclusive control over the propagating material for the plant.



## **Liquidation Losses**

As mentioned above, if the participation exemption applies, capital losses realized on the sale of a participation, are generally not deductible. An exception applies for losses arising as a consequence of the liquidation of a subsidiary. Such liquidation losses may be deductible under certain circumstances.

As of January 1, 2021, a liquidation loss exceeding €5 million will be deductible if all of the following conditions are met:

- The subsidiary to be dissolved is established in the E.U. or the E.E.A.
- The Dutch corporate shareholder holds an interest in the subsidiary of more than 50% (formerly 5%), thereby providing a decisive influence on the subsidiary's activities.
- The liquidation is completed in the third year following the year in which the decision to liquidate was taken or the activities of the subsidiary were terminated (this restriction applies regardless of the amount of the liquidation loss).

## **Tax Treaty Network**

The Netherlands has a robust tax treaty network with more than 90 countries. The jurisdictions with which the Netherlands has a tax treaty currently in force as of April 1, 2024 are listed in the table below.

|                      |            |              |                      |
|----------------------|------------|--------------|----------------------|
| Albania              | Egypt      | Lithuania    | South Africa         |
| Algeria              | Estonia    | Luxembourg   | South Korea          |
| Argentina            | Ethiopia   | Macedonia    | Spain                |
| Armenia              | Finland    | Malawi       | Sri Lanka            |
| Aruba                | France     | Malaysia     | St. Martin           |
| Australia            | Georgia    | Malta        | Suriname             |
| Austria              | Germany    | Mexico       | Sweden               |
| Azerbaijan           | Ghana      | Moldova      | Switzerland          |
| B.E.S. Islands       | Greece     | Montenegro   | Taiwan               |
| Bahrain              | Hong Kong  | Morocco      | Thailand             |
| Bangladesh           | Hungary    | New Zealand  | Tunisia              |
| Barbados             | Iceland    | Nigeria      | Turkey               |
| Belarus              | India      | Norway       | Uganda               |
| Belgium              | Indonesia  | Oman         | Ukraine              |
| Bermuda              | Ireland    | Pakistan     | United Arab Emirates |
| Bosnia & Herzegovina | Israel     | Panama       | United Kingdom       |
| Brazil               | Italy      | Philippines  | United States        |
| Bulgaria             | Japan      | Poland       | Uzbekistan           |
| Canada               | Jordan     | Portugal     | Venezuela            |
| Chile                | Kazakhstan | Qatar        | Vietnam              |
| China                | Kosovo     | Romania      | Zambia               |
| Croatia              | Kuwait     | Saudi Arabia | Zimbabwe             |

|                |               |           |
|----------------|---------------|-----------|
| Curaçao        | Kyrgyzstan    | Singapore |
| Czech Republic | Latvia        | Slovakia  |
| Denmark        | Liechtenstein | Slovenia  |

Additionally, the Dutch Ministry of Finance has concluded new versions of the tax treaties with Andorra, Bangladesh, Belgium, Colombia, Iraq, Kenya, Kyrgyzstan, and Moldova. These tax treaties are currently subject to the domestic ratification process in each country.

### **Multilateral Instrument**

As part of the B.E.P.S. Project, the Multilateral Instrument (“M.L.I.”) was introduced. The M.L.I. aims to prevent international tax avoidance and improve coordination between tax authorities. The Netherlands became a signatory to the M.L.I. in June 2017 and the M.L.I. was ratified by Dutch Parliament in March 2019. The instrument of ratification was deposited with the O.E.C.D. shortly thereafter. A reservation to Article 12 of the M.L.I. was made by the Netherlands in regard to the artificial avoidance of permanent establishment status. Depending on when the instruments of ratification were deposited by other countries, the M.L.I. was effective for the dividends provision as of January 1, 2020, and by January 1, 2021, for other provisions in most treaties.

### **Changes in Dutch Tax Qualification Rules**

On September 19, 2023, two legislative proposals were published that affect the Dutch tax qualification of certain legal entities. These proposals are as follows:

- “Act on adjustment of funds for joint account and exempt investment institutions”
- “Act on adjustment of tax qualification of legal entities”

Both proposals aim to bring the current tax qualification rules for Dutch investment funds, which are often structured as funds for joint account (in Dutch: *fonds voor gemene rekening*) (“F.G.R.”) or limited partnerships (in Dutch: *commanditaire vennootschap*) (“C.V.”) more in line with their original purpose and international standards. On December 19, 2023, both proposals were approved by the Dutch senate and will enter into force on January 1, 2025.

The measures should lead to fewer tax qualification differences for legal entities in international situations. Qualification differences are undesirable because they often result in certain income being taxed twice or not at all. Several measures have been proposed to reduce such qualification differences.

### **Current Dutch C.I.T.A.**

Based on current Dutch tax law, an F.G.R. or C.V. is either open or closed. An open F.G.R. or C.V. is subject to Dutch C.I.T. A closed F.G.R. or C.V. is not subject to Dutch C.I.T. Rather, the participants in a closed F.G.R. or C.V. are taxed.

An F.G.R. or C.V. is considered an open F.G.R. or C.V. – and therefore subject to Dutch C.I.T. – if participations in the entity are freely transferable. Free transferability does not exist if a transfer by a member requires the prior unanimous consent of all participants. Moreover, transfers of participations in an F.G.R. typically are possible



only to (i) the F.G.R., itself, by means of a redemption or (ii) relatives by blood or marriage in the direct line of the participant.

### Dutch C.I.T.A. as of January 1, 2025

As of January 1, 2025, the definition of the F.G.R. will change. As a general rule, an F.G.R. will not be subject to Dutch C.I.T. and therefore will be considered “closed” (*i.e.*, transparent). However, if the participations in the F.G.R. are freely transferable on a regulated market or comparable trading platform, the F.G.R. will be regarded as open, and will be subject to Dutch C.I.T. The current consent requirement as a distinguishing criterion for tax purposes will be abolished.

A C.V. will in principle always be treated as “closed” and transparent for Dutch C.I.T. purposes, and will no longer be subject to Dutch C.I.T. Instead, as of January 1, 2025, the participants in the C.V. will be subject to Dutch personal income tax or Dutch C.I.T. on their share in the result of the C.V.

## TAX RULINGS

On July 1, 2019, the Dutch Ministry of Finance introduced its new tax ruling practice for rulings with an international character. Reasons for updating the international tax ruling practice were (a) to ensure that tax rulings will only be granted where the relevant taxpayer has sufficient economic nexus with the Netherlands and (b) to improve overall transparency of the Dutch tax ruling practice.

A taxpayer will be deemed to have sufficient economic nexus if (i) it forms part of a group that carries on commercial operating activities in the Netherlands, (ii) the commercial, operating activities are performed for the account and risk of the taxpayer for which sufficient personnel is available at group level in the Netherlands, and (iii) the commercial operating activities fit with the function of the taxpayer within the group.

An international tax ruling will not be issued when (a) saving Dutch or foreign taxes is the sole or decisive reason for the actions and transactions to be covered in the tax ruling or (b) the subject of the tax ruling primarily relates to the tax consequences of direct transactions with companies that are resident in a low-tax jurisdiction or an E.U. blacklisted jurisdiction.<sup>5</sup>

It is therefore possible that a ruling request will be denied even though the economic nexus requirements are met.

An international tax ruling can be issued for the following topics:

- Application of the participation exemption
- Qualification of hybrid financial instruments and hybrid entities
- Application of C.F.C. provisions
- The presence or absence of a permanent establishment of a foreign entity in the Netherlands

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<sup>5</sup> See **Controlled Foreign Corporations** for countries based in low-tax jurisdictions and blacklisted jurisdictions.

- The extra-territorial taxation of foreign shareholders of a Dutch holding company
- Exemption from Dutch dividend withholding tax
- Advance pricing agreements

In order to enhance transparency regarding the tax ruling process, an anonymous summary of the tax ruling will be published on the website of the Dutch Ministry of Finance. The summary contains a brief explanation of the facts and circumstances, as well as the main conclusions derived from transfer pricing reports or other documentation, on which the ruling is based. A summary will also be published when the tax ruling was denied or retracted including the reasons for the denial.

When filing an international tax ruling request, the taxpayer can indicate the taxable period covered by the tax ruling. In general, a tax ruling will be valid for a maximum of five years. If the facts and circumstances justify an exception, as in the case of long-term contracts, a maximum period of ten years may be applied, but a mid-term review is required.

The tax ruling will be embodied in a settlement agreement between the Dutch tax authorities and the taxpayer. The settlement agreement will contain (a) the critical assumptions on which the tax ruling is based and (b) an acknowledgment that the settlement agreement will be terminated immediately if there are changes in relevant tax laws.

In recent years, there are reports that the Dutch tax authorities use information received in a ruling request as a roadmap in a tax examination initiated after the ruling request is denied or withdrawn.

*“In recent years, there are reports that the Dutch tax authorities use information received in a ruling request as a roadmap in a tax examination initiated after the ruling request is denied or withdrawn.”*

## MINIMUM TAX RATE ACT 2024

On January 1, 2024, the Minimum Tax Rate Act 2024 (also known as ‘Pillar Two’) entered into force. The Minimum Tax Rate Act 2024 applies to constituent entities of both multinational groups and domestic groups, with an annual revenue exceeding €750 million. A number of exceptions apply for governmental entities, pension funds, and group companies with actual economic activities or limited revenues and profits.

The Minimum Tax Rate Act 2024 provides for a profit tax with a minimum effective tax rate of 15% for each country in which the group operates. This means that if the effective tax rate in a country is lower than 15%, a top-up tax is levied. The top-up tax may be applied in three different ways:

- **Income Inclusion Rule.** A top-up tax is levied at the level of the ultimate parent entity.
- **Qualified Domestic Top-Up Tax.** A top-up tax can also be imposed at the level of a certain group-company located in a country that has also implemented Pillar Two. In such a case, the Netherlands will provide a tax credit against the Income Inclusion Rule, so that in principle, no double taxation should occur.

- **Under Taxed Payment Rule.** Should the Income Inclusion Rule along with the Qualified Domestic Top-Up Tax fail to lead to the desired minimum 15% levy, the Netherlands will charge top-up taxes on the profits earned by low-tax companies elsewhere in the group. The Under Taxed Payment Rule is considered a backstop for cases in which Pillar Two is not applied in all countries concerned.

Constituent entities located in the Netherlands and to which the Minimum Tax Rate Act 2024 applies must submit a top-up tax information return to the Dutch Tax Authorities for each reporting fiscal year, unless the top-up tax information return is filed in another country and the Dutch Tax Authorities receive it via international exchange of information. In that case, the constituent entities must notify the Dutch Tax Authorities of the identity of the entity that is filing the top-up tax information return, as well as the jurisdiction in which it is located. Under certain conditions, it is possible to have a single entity submit this information on behalf of all group entities established in the Netherlands.

The top-up tax information return or the notification must be submitted no later than 15 months after the last day of the reporting fiscal year. A period of 18 months applies to the first reporting fiscal year, meaning that the first deadline will be June 30, 2026 for the financial year 2024.

A group must submit a tax return if a top-up tax is due in the Netherlands. The tax return must be submitted no later than 17 months after the last day of the reporting fiscal year. A period of 20 months applies to the first reporting fiscal year, meaning that the first deadline will be August 31, 2026.

## DIVIDEND WITHHOLDING TAX

### **Withholding Tax on All Dividend Payments**

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%. Since January 1, 2018, distributions of profits to a qualifying member<sup>6</sup> by a Dutch cooperative used as a holding vehicle are also subject to Dutch dividend withholding tax. The rate may be reduced under an applicable income tax treaty. Under certain conditions, the dividend withholding tax payable by a Dutch holding company may be reduced by 3% in order to compensate for foreign withholding taxes imposed on incoming dividends that cannot be claimed as a credit by the holding company when the Dutch participation exemption applies.

No dividend withholding tax is levied on dividends paid by a Dutch-resident entity to nonresident corporate shareholders, if all the following conditions exist:

- The corporate shareholder is a tax resident of a country within the E.U. or E.E.A., or a country with which the Netherlands has concluded a tax treaty containing a provision covering dividends.

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<sup>6</sup> A qualifying member is a member that is entitled to at least 5% of the annual profits or the liquidation proceeds of the Dutch cooperative.

- The Dutch participation exemption, which in principle requires a minimum shareholding of 5%, would have been applicable to the shareholding in the Dutch entity distributing the dividends had the recipient of the dividends been a resident of the Netherlands.
- The corporate shareholder does not fulfill a similar function as a Dutch exempt investment institution or Dutch zero-taxed investment institution.
- The corporate shareholder is the beneficial owner of the dividends.

Under an anti-abuse rule, the dividend withholding exemption does not apply if (a) the main purpose, or one of the main purposes, for which the foreign shareholder holds its interest in the Dutch entity is to avoid Dutch dividend withholding tax (a subjective test) and (b) the structure or transaction is considered artificial and not set up for valid business reasons (an objective test).

A structure or transaction is considered artificial if and to the extent it was not put into place for valid business reasons that reflect economic reality. Valid business reasons may be present if, *inter alia*, the nonresident company (i) conducts a material business enterprise and the Dutch shareholding is part of the business enterprise's assets, (ii) is a top-level holding company that carries out material management, policy, and financial functions for the group it heads, or (iii) functions as an intermediate holding company performing a linking function within the group in relation to the Dutch member. An intermediate holding company can only perform a linking function if its direct or indirect corporate shareholder and its direct or indirect subsidiary or subsidiaries each conduct a material business enterprise.

In the case of an intermediate holding company, the company must also meet the following minimum substance requirements:

- At least half of the managing directors reside or are established in the state in which the intermediate holding company is tax resident.
- The resident managing directors of the intermediate holding company have sufficient professional knowledge to perform their duties.
- The intermediate holding company has personnel qualified for the proper execution and registration of the planned transaction.
- All management board meetings are held in the resident state of the intermediate holding company and are in principle attended by all board members.
- All decisions of the management board are made and executed in the resident state of the intermediate holding company.
- The bank account(s) of the company are managed and maintained in or from the resident state of the intermediate holding company.
- The resident managing directors should be solely authorized to approve all transactions on the company's main bank accounts.
- The bookkeeping of the company is done in the resident state of the intermediate holding company.

- The company's address is in the resident state of the intermediate holding company.
- The company is not considered to be resident of another country.
- The company runs real risks with respect to its financing, licensing, or leasing activities.
- The company finances its participations with a minimum of 15% equity.
- The company must incur €100,000 in salary expenses for competent staff, not merely supporting, staff.
- The company has a fully equipped office space at its disposal for at least 24 months.



On February 26, 2019, the E.U. Court of Justice (“E.C.J.”) rendered a decision in the so-called “Danish Cases” addressing the definition of tax avoidance in the context of the substance requirements and beneficial ownership.

The court ruled that E.U. Member States are must deny the application of exemptions from tax – such as the dividend withholding tax exemption – to a recipient of income that is a conduit company and not the beneficial owner of income it receives. Whether a specific recipient of a dividend is a beneficial owner or merely a conduit company is a factual question and the facts of each case must be analyzed to reach a conclusion.

As a result of the Danish Cases, the Dutch C.I.T.A. was changed as of January 1, 2020, giving the Dutch tax authority the opportunity to demonstrate that a structure is abusive, even if the relevant substance criteria are satisfied. Consequently, the substance requirements no longer serve as a safe haven preventing imposition of Dutch dividend withholding tax. The substance criteria function as mere indicators for the non-abusive character of a specific fact pattern.

With respect to the dividend provision of an income tax treaty as of January 1, 2020, and with respect to other provisions of an income tax treaty as of January 1, 2021, the P.P.T. of the M.L.I. applies to most of the tax treaties concluded by the Netherlands. This suggests that protection under the tax treaty will not be available where the principal purpose of setting up the intermediary holding company was to obtain a tax treaty benefit.

Currently, there are two cases pending with the Dutch Supreme Court. These cases concern dividends distributed by companies established in the Netherlands to Belgian holding companies, of which the direct or indirect shareholders in Belgium are resident members of the same family. In one of the cases, the holding company did not carry on a business of substance. In the other case, the holding company did carry on a business of substance in connection with the holding of shares in other companies, but the shares in the company that distributed the dividend could not be functionally attributed to that business. In both cases, the Court of Appeals in Amsterdam ruled that there was abuse, so that the dividend withholding tax exemption could not be applied. According to the conclusion of the Advocate-General to the Dutch Supreme Court, the appeal in both cases must be rejected because the Court of Appeals Amsterdam applied the correct legal standard and the actual conclusions are not incomprehensible. The Dutch Supreme Court judgments are expected over the course of 2024.

## **Repurchase Facility**

Under specific conditions, listed companies can repurchase shares without dividend tax. During the debate on the Tax Plan 2024, it was determined by amendment that this repurchase facility would be abolished by 2025. The government advised against abolishing the facility, and critical comments were submitted by the business community. On May 16, 2024, the formation of the new government of the Netherlands reached the outline of an agreement to retain the repurchase. It is expected that the facility will remain in place.

## **Additional Withholding Tax on Dividend Payments**

As of January 1, 2024, the Netherlands introduced an additional withholding tax in the case of intragroup profit distributions to shareholders located in certain low tax jurisdictions. The rules, including the tax rate, will be in line with the conditional withholding tax on intragroup interest and royalty payments discussed in **Conditional Withholding Tax**.

## **PROPOSED EXIT TAX**

A legislative proposal was submitted to parliament introducing an exit tax in the Dutch dividend withholding tax act for certain cross-border reorganizations. It was intended that, if enacted, the proposal would have a retroactive effect from December 8, 2021 at 9:00 A.M.

The primary reason for introducing the proposal was to create a deterrent for listed companies such as Unilever and Royal Dutch Shell to move their residence abroad and specifically to the U.K.

In mid-2022, the government advised the lower house against passing this law. Although the proposal is still formally pending, the likelihood of enactment is very limited.

## **CONDITIONAL WITHHOLDING TAX**

One of the attractions of the Netherlands is that in principle no withholding tax is levied over outgoing interest and royalty payments. However, in order to combat international tax avoidance and to prevent the Netherlands from being used as a gateway for interest and royalty payments to low-tax jurisdictions, a conditional withholding tax (in Dutch, “*bronbelasting*”) on interest and royalty payments to affiliated entities located in low-tax jurisdictions came into effect on January 1, 2021. The rate of withholding tax is equal to the highest rate of corporation income tax applicable at that point in time (25.8% in 2024). As of January 1, 2024, the scope of this act has been broadened to include dividend payments.

The conditional withholding tax applies only to payments to affiliated entities. An entity is deemed to be affiliated if (a) the recipient company has a qualifying interest in the paying company, (b) the paying company has a qualifying interest in the recipient company, or (c) a third company has a qualifying interest in the recipient company and the paying entity.



An interest in a company is considered a qualifying interest if the recipient company directly or indirectly maintains a decision-making influence at the level of the paying company. This is the case where the recipient company can exercise more than 50% of the voting rights of the paying company. In addition, companies can be affiliated, if they are part of a cooperating group that jointly have qualifying interests in the paying company.

Low-tax jurisdictions are jurisdictions with a statutory corporation income tax rate of less than 9% and jurisdictions that are included on the E.U. list of noncooperative jurisdictions.<sup>7</sup> Where the low-tax jurisdiction is a jurisdiction with which the Netherlands has concluded an income tax treaty, this jurisdiction will not be deemed to be a low-tax jurisdiction until three calendar years have passed from the time the jurisdiction is listed in a ministerial decree or included on the E.U. list of noncooperative jurisdictions. The aim of the three-year period is to give a tax treaty partner time to renegotiate the existing tax treaty.

In addition to direct interest, royalty, and dividend payments to entities in low-tax jurisdictions, the conditional withholding tax in principle applies to the following payments:

- Payments to a foreign affiliated company that is not a resident of a low-tax jurisdiction, but has a permanent establishment in a low-tax jurisdiction to which the payment should be allocated.
- Payments to a foreign affiliated company that is not a resident of a low-tax jurisdiction but is considered transparent for Dutch tax purposes and non-transparent in the state where the shareholders of the foreign affiliated company reside (*i.e.*, a hybrid company).
- Payments to a foreign affiliated company that is not a resident of a low-tax jurisdiction but is considered non-transparent for Dutch tax purposes and transparent in the state of its residence and its shareholders are residing in a low-tax jurisdiction (*i.e.*, a hybrid company). This provision does not apply where the paying company or the recipient company proves that each of the ultimate beneficiaries with a direct qualifying interest in the hybrid company or each of the beneficiaries participate in a cooperating group) meets the following conditions:
  - The ultimate beneficiary owner is deemed to be the owner of the interest income in its country of residence.
  - The ultimate beneficiary would not have been subject to the conditional withholding tax without the interposition of the hybrid company.

In certain abusive situations, the conditional withholding tax also applies to interest, royalty, and dividend payments to a foreign affiliated company that is not a resident in a low-tax jurisdiction. This is the case if there is an artificial arrangement or series of arrangements and an entity in the jurisdiction that is not a low-tax jurisdiction is interposed with the main purpose, or one of the main purposes, being the avoidance of the conditional withholding tax.

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<sup>7</sup> See **Controlled Foreign Corporations** for countries based in low-tax jurisdictions and blacklisted jurisdictions.

*“An interest in a company is considered a qualifying interest if the recipient company directly or indirectly maintains a decision-making influence at the level of the paying company.”*

In certain cases, the conditional dividend withholding tax should be treated as an addition to the regular dividend withholding tax at a statutory rate of 15%. This is because the conditional dividend withholding tax on dividends distributed (statutory rate of 25.8%) will generally apply to distributions to low-taxed jurisdictions and in certain abusive or hybrid situations. These situations are also subject to the regular dividend withholding tax at a statutory rate of 15%. Therefore, the conditional dividend withholding tax will be reduced with any regular dividend withholding tax (15% or less), so that a maximum tax rate of 25.8% is levied on the dividend distribution.

## EXTRA-TERRITORIAL TAXATION AND ANTI-ABUSE RULES

In addition to dividend withholding tax levied on dividends distributed, a nonresident corporate shareholder of a Dutch holding entity may be subject to Dutch corporation income tax on the dividends or capital gains derived from its shareholding if two facts exist. The first is that the nonresident company holds 5% or more of the shares, or class of shares, of the Dutch holding company (a “Substantial Shareholding”), with a main purpose, or one of the main purposes being, to avoid the levy of Dutch income tax with respect to another person. The second is that there is an artificial arrangement or series of artificial arrangements similar to the artificial structure or transactions described above in **Minimum Tax Rate Act 2024**.

In 2024, Dutch corporation income tax will be levied at a rate of 19.0% for the first €200,000 and 25.8% for the excess. Any dividend withholding tax levied can offset the corporation income tax due.

These anti-abuse provisions are mainly aimed at individuals who own a Dutch holding company through an offshore entity. Active foreign companies and private equity funds that own 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 for real estate transfer tax (“R.E.T.T.”) in certain circumstances. R.E.T.T. is levied if a purchaser acquires real estate or at least one-third 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 its 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. As of January 1, 2023 the R.E.T.T. rate is 10.4%. For residential real estate bought by individuals for their own long-term accommodation, a reduced rate of 2% applies.

First-time buyers on the housing market between the ages of 18 and 34 years who are acquiring residential real estate with a maximum acquisition price of €510,000 are eligible for a R.E.T.T. exemption. The first-time buyer can use the exemption only once.

## IRELAND

### Author

James Somerville  
A & L Goodbody LLP  
Dublin, Ireland

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 ideal jurisdiction for a holding company would include the following criteria:

- 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
- Reduced foreign tax on dividends received from the jurisdiction

The author acknowledges the contribution of his colleagues Darragh Noone and Cian Ryan, also of A&L Goodbody LLP, in updating this chapter of the article.

## RECENT DEVELOPMENTS

### Update on Ireland's International Tax Strategy

In tandem with Finance Act 2020, the Irish government published an update in January 2019 on continuing progress in modifying the Irish international tax strategy. Ireland was one of the first ten jurisdictions to be evaluated for the second time under the new terms of reference by the O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes, achieving the top rating of "Compliant." Ireland has ratified the B.E.P.S. Multilateral Instrument ("M.L.I.") and has demonstrated continued commitment to the global automatic exchange of information. Ireland has implemented the third, fourth, fifth, sixth and seventh revisions of the Directive on Administrative Cooperation ("D.A.C."). The sixth iteration of D.A.C. requires tax advisors and companies to disclose any tax planning arrangements that meet certain hallmarks indicative of aggressive tax planning. Ireland has been supportive of such measures and was one of only three E.U. Member States to have pre-existing mandatory disclosure rules in place. D.A.C. 7, which addresses the digital economy and extends the scope of existing exchange of information provisions between E.U. Member States, was also implemented by Ireland under Finance Act

2021 and Finance Act 2022. D.A.C. 7 provides for digital platform operators to collect information on reportable sellers utilizing their platforms and to annually report such information to the Irish Revenue Commissioners, who will in turn share this with relevant E.U. Member States.

Ireland has been actively engaged in the O.E.C.D. B.E.P.S. Project and the work of the Tax Force on the Digital Economy, and has also transposed anti-hybrid rules into its domestic legislation under the E.U.-Anti-Tax Avoidance Directives (“A.T.A.D.”). On October 7, 2021, Irish Minister for Finance Paschal Donohoe confirmed that Ireland would sign up for the O.E.C.D. International Tax Agreement on Pillars One and Two. On December 15, 2022, the Council of the E.U. unanimously adopted the minimum tax directive, which seeks to implement Pillar Two at an E.U. level, including the application of a minimum effective tax rate of 15% for groups with an annual revenue exceeding €750 million. Ireland transposed these provisions into national law pursuant to Finance (No. 2) Act 2023. These provisions apply to fiscal periods commencing on or after December 31, 2023, with the exception of the undertaxed profits rule which will apply for fiscal years starting on or after December 31, 2024. Companies with an annual revenue of less than €750 million will continue to pay corporation tax at the existing rate of 12.5%.

### **B.E.P.S.**

Irish tax policy for attracting jobs through favorable tax rules may be affected by the O.E.C.D.’s base erosion and profit shifting initiative (the “B.E.P.S. Project”) and the subsequent B.E.P.S. Action Plan, for which the final reports were published in October 2015. The B.E.P.S. Action Plan identified six key problem areas contributing to the growth of inappropriate profit shifting, including intragroup financial transactions, harmful tax regimes, and digital goods and services.

Ireland has adopted many of the provisions recommended in the B.E.P.S. Action Plan, including a general anti-avoidance rule (“G.A.A.R.”), domestic provisions limiting tax relief on intragroup debt, transfer pricing legislation, and provisions taxing dividends from non-trading foreign subsidiaries at a higher rate of corporate tax than the headline 12.5% rate.

Overall, the Irish government’s response has been to welcome the B.E.P.S. Project and the O.E.C.D.’s coordinated effort to deal with the challenges posed by B.E.P.S. The stated position in Ireland is that the B.E.P.S. Project cannot succeed without coordinated multilateral action. While Ireland recognizes that the B.E.P.S. Project involves certain challenges, it also sees new opportunities arising for Ireland and other small countries. 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 corporate tax policy since the 1950’s.

Ireland’s reaction to the principal final reports was as follows:

- **Action Item 1 (Digital Economy):** As referenced above, Ireland implemented D.A.C. 7 with respect to information collected by digital platform operators under Finance Act 2021 and Finance Act 2022. Relevant activities occurring on or after January 1, 2023 are in scope for reporting and the first annual reporting obligation for platform operators was on January 31, 2024.

- **Action Item 2 (Hybrid Mismatches):** Ireland’s anti-hybrid rules came into force January 1, 2020, transposing the first and most substantive part of the A.T.A.D. 2 anti-hybrid rules. Rules regarding reverse hybrids came into effect January 1, 2022.
- **Action Item 3 (Controlled Foreign Corporation Rules):** Controlled foreign corporation (“C.F.C.”) rules were introduced January 1, 2019. Ireland has opted for Option B in determining the attribution of income of a C.F.C. to its parent.
- **Action Item 4 (Interest Deductions):** Ireland introduced the interest limitation rule under Finance Act 2021, which took effect for accounting periods commencing on or after January 1, 2022.
- **Action Item 5 (Harmful Tax Practices):** As a pre-emptive action, Ireland moved to phase out the so-called “double Irish” tax structure in 2014 and introduced its own O.E.C.D.-compliant patent tax regime (the “Knowledge Development Box” or “K.D.B.”) in 2015. The K.D.B. was the first such incentive to be recognized as being fully compliant with the rules agreed upon during the B.E.P.S. initiative.
- **Action Item 6 (Treaty Abuse):** Over time, measures to protect against treaty abuse should become part of Ireland’s treaties. Ireland’s pre-existing G.A.A.R. meets the required standard under A.T.A.D.
- **Actions Items 8, 9, and 10 (Transfer Pricing):** Ireland has followed Recommendation 6 of the Review of Ireland’s Corporate Tax Code, acknowledging that it should provide for the application of the O.E.C.D. 2017 Transfer Pricing Guidelines incorporating B.E.P.S. Actions 8, 9, and 10 in Irish legislation. Ireland has revised its transfer pricing rules to incorporate these Guidelines. The new rules are effective for accounting periods beginning on or after January 1, 2020.
- **Action Item 13 (C-b-C Reporting):** Ireland signed the O.E.C.D.’s multilateral competent authority agreement in January 2016 and separately introduced Country-by-Country Reporting legislation in Finance Act 2015.
- **Action Item 15 (Multilateral Instrument):** Ireland played its part in the negotiations leading to the adoption of the Multilateral Instrument on November 24-25, 2016. Ireland was one of the first countries to sign the M.L.I. in June 2017 and deposited its instrument of ratification with the O.E.C.D. on January 29, 2019, meaning the Multilateral Instrument came into force in Ireland on May 1, 2019.

### **F.A.T.C.A.**

On December 21, 2012, Ireland concluded the Ireland-U.S. intergovernmental agreement in accordance with the provisions of the U.S. Foreign Account Tax Compliance Act (“F.A.T.C.A.”). Implementing legislation was introduced in Finance Act 2013, compelling Irish reporting financial institutions to collect and return certain information to the Irish tax authorities for exchange with the I.R.S.

While, initially, domestic implementation regulations classified relevant holding companies as financial institutions for F.A.T.C.A. purposes, that was found to be

inconsistent with the I.G.A. definition of a financial institution. An amendment to the domestic regulations clarified that a holding company will only be considered a financial institution for F.A.T.C.A. purposes if it meets the definition of one of the four financial institution categories set out in the I.G.A. Otherwise, the holding company should be classed either as an “active” or “passive” non-financial foreign entity, as the circumstances dictate.

### **C.R.S.**

Ireland is a signatory jurisdiction to the Multilateral Competent Authority Agreement on Automatic Exchange of Finance Account Information, which was entered into by Ireland in its capacity as a signatory to the Convention on Mutual Administrative Assistance on Tax Matters. Ireland has introduced legislation to implement the O.E.C.D.’s common reporting standard (“C.R.S.”) internationally and to implement Directive 2014/107/E.U. on Administrative Cooperation in the field of Taxation (“D.A.C. 2”) with respect to the exchange of information between E.U. Member States. The C.R.S. has been effective in Ireland since January 1, 2016.

### **State Aid Investigation**

On June 11, 2014, the European Commission (“the Commission”) announced that it opened an in-depth investigation of whether decisions by tax authorities in Ireland with regard to the corporation 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.

### **European Commission Decision Regarding Apple and Ireland**

The Commission published its much-anticipated decision on the Apple case on December 19, 2016, against which both Apple and the Irish government have lodged appeals with the Court of Justice of the European Union. The E.U. General Court (“E.G.C.”) heard oral arguments from both Ireland and Apple in September 2019. The Department of Finance conducted negotiations with Apple over setting up a holding account for the €13 billion the Commission says is due to Ireland in back taxes, pending the outcome of the appeals. Although in October 2017, the Commission indicated it was taking Ireland to the E.C.J. over delays in recovering the money, Apple deposited €13.1 billion plus €1.2 billion in interest into an escrow account set up by the Irish government.

While the appeals process is ongoing – and several years are expected to pass before a conclusion is reached – the money will remain in escrow and will be invested in a managed account in order to maintain its value. Notably, the total amount of aid payable has since been reduced to account for taxes paid to other countries, following approval granted by the Irish Minister of Finance to reduce same on an annual basis.

### **Annulment by E.G.C. of the Decision of the European Commission**

In a decision announced on July 15, 2020, the E.G.C. annulled the decision taken by the Commission regarding the Irish tax rulings, and held in favor of Apple. In the view of the E.G.C., the European Commission did not succeed in showing to the requisite legal standard that there was an advantage for the purposes of Article 107(1) T.F.E.U.

*“Ireland is a signatory jurisdiction to the Multilateral Competent Authority Agreement on Automatic Exchange of Finance Account Information, which was entered into by Ireland in its capacity as a signatory to the Convention on Mutual Administrative Assistance on Tax Matters.”*



In the press release announcing the decision, the E.G.C. endorsed the Commission's approach to normal taxation under the Irish tax law, using the tools developed within the O.E.C.D., such as the arm's length principle. These tools may be applied in order to check whether the level of taxable profits endorsed by the Irish tax authorities corresponds to that which would have been obtained under market conditions.

However, the E.G.C. considered that the Commission erred in its primary line of reasoning. Under the approach adopted by the Commission, all the income arising from the Apple Group intellectual property licenses held by A.S.I. and A.O.E. should have been taxed in Ireland as income from Irish-based operations. To support that approach, the Commission should have demonstrated the value of the activities actually carried out by the Irish branches themselves. That demonstration was not undertaken and the E.G.C. could not ignore the strategic decisions taken and implemented outside of those branches.

In addition, the E.G.C. concluded that the Commission did not succeed in demonstrating the existence of methodological errors in the Irish tax rulings which led inappropriately to a reduction in ASI and AOE's taxable profits in Ireland. The defects identified by the Commission were not, in themselves, sufficient to prove the existence of an advantage for the purposes of Article 107(1) T.F.E.U.

The Commission lodged an appeal before the E.C.J. on September 25, 2020. The primary ground of the appeal relates to the rejection by the E.G.C. of the Commission's primary line of reasoning as to the existence of a tax advantage. The Commission asserted that the E.G.C. failed to have regard to the analysis contained in the Commission's decision as to the functions performed by the head offices and Irish branches to justify the allocation of the Apple IP licenses to the Irish branches. The Commission also asserted that the E.G.C. contravened the separate entity approach and the arm's length principle by incorrectly relying on functions carried out by Apple Inc. in order to reject the allocation of I.P. to the Irish branches, as well as by finding that acts of the directors of A.S.I. and A.O.E. constitute functions performed by their head offices.

Oral arguments in relation to the Commission's appeal were heard before the E.C.J. in May 2023. The Irish government is of the opinion that the E.G.C.'s decision to annul the Commission's decision was correct. In November 2023, Advocate General Pitruzzella ("A.G.") issued his opinion, siding with the Commission. The A.G. recommended that the E.C.J. annul the decision of the E.G.C., on the basis that the E.G.C. did not correctly assess "the substance and consequences of certain methodological errors that, according to the Commission decision, vitiated the tax rulings", and that the case should be referred back to the E.G.C. for a new decision. The A.G.'s opinion is non-binding on the E.C.J., which is expected to issue its decision on the case in 2024.

## **A.T.A.D.**

### **A.T.A.D. 1**

The Anti-Tax Avoidance Directive ("A.T.A.D.") was adopted as Council Directive 2016/1164/E.U. on July 12, 2016, and had to be implemented by all E.U. Member States by January 1, 2019. Among the measures in A.T.A.D. is an interest limitation rule ("I.L.R.") which closely follows the provisions of B.E.P.S. Action 4. The I.L.R.

was introduced in Ireland under Finance Act 2021, and took effect for accounting periods commencing on or after January 1, 2022. The effect of the I.L.R. is to reduce the maximum tax deduction allowed for net borrowing costs to 30% of the taxpayer's E.B.I.T.D.A. However, there are a number of exclusions from the I.L.R. One is that legacy debt where the terms were agreed prior to June 17, 2016, and have not changed. Another is the adoption of a *de minimis* threshold, under which the I.L.R. will not apply if an Irish interest group has net interest costs of less than €3 million.

#### A.T.A.D. 2

A.T.A.D. 2 extends the hybrid mismatch definition of A.T.A.D. to include mismatches resulting from arrangements involving permanent establishments, hybrid transfers, imported mismatches, and reverse hybrid entities. Ireland transposed the rules with effect from January 1, 2020, except for the reverse hybrid rule which took effect as of January 1, 2022. This brings domestic law into line with A.T.A.D. 2 in respect to third country mismatches. Those mismatches involve interest paid on a debt instrument issued by an Irish tax resident entity that is deductible on a current basis in Ireland while the recipient in a third country entity benefits from a participation exemption upon receipt of the payment. Ireland strongly supported the quick adoption of A.T.A.D. 2.

#### A.T.A.D. 3

A.T.A.D. 3 is a proposal for a directive with the stated aim of preventing the misuse of shell entities for tax purposes. Covered entities would be required to report on various substance indicators, and failure to comply could result in financial penalties and the denial of a certificate of tax residence. The final iteration of A.T.A.D. 3 has not yet been agreed upon. The original objective of the E.U. Commission and the E.U. Parliament was for the directive to enter into force from January 1, 2024. This implementation date has now been postponed until January 1, 2025, however, as of May 2024, it is not apparent that the deadline will be met.

## 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. The income is more likely to be characterized as passive income, as it will be composed of 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 below in **Dividends Paid by Irish Holding Companies**. This rate of tax is low compared with other jurisdictions. In addition, Ireland's double tax treaty network is likely to give a credit for overseas tax.<sup>1</sup> 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

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<sup>1</sup> Ireland has signed double taxation treaties with 76 countries, 74 of which are in effect.



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.

Under the O.E.C.D. Pillar Two framework, a 15% global minimum level of taxation has been introduced. The Council of the E.U. unanimously adopted the minimum tax directive on December 15, 2022, to implement these rules consistently across E.U. Member States. Pillar Two has the effect of increasing Ireland's corporation tax rate to 15% in respect of large groups that meet the annual threshold of at least €750 million of consolidated revenue in at least two of the four preceding years. However, the Irish government has retained the existing 12.5% rate of corporation tax for all other trading entities. Ireland transposed the Pillar Two provisions into national law pursuant to Finance (No. 2) Act 2023, and the provisions apply to fiscal periods commencing on or after December 31, 2023, with the exception of the undertaxed profits rule which will apply for fiscal years starting on or after December 31, 2024.

## DIVIDENDS RECEIVED BY IRISH COMPANIES

Dividends received by an Irish holding company from foreign subsidiaries do not qualify for a participation exemption, as they do 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% or greater 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 in effect.

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 a company that (i) is resident in an E.U. Member State or treaty country or a country that has ratified the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters and (ii) has issued shares that are substantially and regularly traded on a stock exchange in an E.U. Member State, a treaty partner country of Ireland, or a country that has ratified the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters or is a 75%-owned subsidiary of that company.

Where dividends are paid by one of these companies on a shareholding of less than 5%, the dividends are deemed to have been paid out of trading profits. Thus, 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 thus, the 12.5% rate will automatically apply once again. In other cases, an apportionment will be needed to determine the part of the dividend to which the 12.5% rate applies and the balance, which will remain liable at 25%.

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.



With a 12.5% rate payable on most dividends and foreign tax credit availability – including onshore pooling, which enables excess credits derived from high-tax subsidiaries to be offset against dividends from low tax subsidiaries – it is commonly possible to avoid Irish tax arising in a group holding company.

## 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 imposed at the rate of 25%, a number of exceptions exist under domestic law that make the withholding tax less problematic in Ireland than in many other European holding company jurisdictions. Typically, an Irish holding company that is controlled directly or indirectly by persons resident in an E.U. Member State or a treaty country should not suffer any withholding tax on dividend payments.

The Irish legislation implementing the E.U. Parent-Subsidiary Directive (“P.S.D.”) allows an Irish company to make distributions free of withholding tax to E.U.-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 documentation requirements exist to preclude the application of this exemption.

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

- 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 treaty country, resident for tax purposes in that country.
- A company that is resident in an E.U. Member State (other than Ireland) or in a treaty country, and which is not under the direct or indirect control of a person, or persons, resident in Ireland.
- A company that (i) is neither a resident of Ireland nor a resident of any other E.U. Member State or a treaty country 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 treaty country.<sup>2</sup>

Note, however, that if the majority of voting rights in the parent company are controlled directly or indirectly by persons who are neither resident in an E.U. Member State nor resident in a country with which Ireland has an income tax treaty in effect, the exemption will apply only if the parent company exists for *bona fide* commercial reasons and does not form part of any arrangement for which a main purpose is the avoidance of income tax, corporation tax, or capital gains tax.

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

<sup>2</sup> Where there is a chain of ownership, the exemption does not apply if an Irish-resident company is in the chain.

**“No documentation requirements exist to preclude the application of this exemption.”**

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-resident company will be exempt from Irish corporate tax on its chargeable gains on the 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 a foreign company and the following criteria are met:

- At the time of the disposal, the foreign company is resident, for tax purposes, in the E.U. or in a treaty country.
- The company making the disposal must be, directly or indirectly, beneficially entitled to (i) at least 5% of the company's ordinary share capital, (ii) at least 5% of the profits available for distribution to the shareholders of the company, and (iii) at least 5% of the assets of the company available for distribution to shareholders upon a winding up of the business.
- The disposal must occur during an uninterrupted period of 12 months during which the Irish company (i) directly or indirectly holds at least 5% of the ordinary share capital of the company, (ii) is beneficially entitled to at least 5% of the profits available for distribution to the shareholders, and (iii) 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 the disposal of shares in an investee company (*i.e.*, the foreign subsidiary), either the investee company carried 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.

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

The A.T.A.D. interest limitation rules were introduced in Ireland under Finance Act 2021, and took effect for accounting periods commencing on or after January 1, 2022. Prior to these rules, an Irish holding company could be financed principally by way of debt, as an Irish tax deduction was potentially available for interest on monies borrowed to finance the acquisition of shares. As discussed in **A.T.A.D. 1**,

above, the effect of the I.L.R. is to reduce the maximum tax deduction allowed for net borrowing costs to 30% of the taxpayer's E.B.I.T.D.A., though a number of exclusions exist in respect of legacy debt and where the interest group has net interest costs of less than €3 million.

Interest is allowed as a deduction if the underlying indebtedness is used in acquiring any part of the ordinary share capital of any of the following companies:

- A trading company
- A company whose income consists mainly of real estate rental income
- A direct holding company of a company referred to above
- A company whose business consists wholly or mainly of holding stocks, shares, or securities of a company that is a trading company indirectly through an intermediate holding company or companies
- A company whose business consists wholly or mainly of the holding of stocks, shares, or securities directly in a company whose income consists mainly of real estate rental income

A deduction is also allowed for interest on funds borrowed, if the funds are used wholly and exclusively for the purposes of the borrower's trade or business, or that of a company connected with it.

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 lent, or a company connected to it ("the investee borrower"). During the period from the application of the loan proceeds until the interest is paid, at least one director of the Irish holding company must be a director of the investee borrower. 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 the investee borrower 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, as this would jeopardize the deduction.

In addition, anti-avoidance measures restrict the deductibility of interest where (i) intragroup borrowings are used to finance the acquisition of group assets or (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 recharacterization 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 not to have the interest 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) the amount is payable in the ordinary course of the Irish company's trade, and (iv) the payment would not otherwise be deductible.

## FINANCING OF 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 imposed 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 a relevant income tax 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 treaty country (*i.e.*, “relevant territories”) is exempt from the withholding tax, provided the relevant territory imposes a tax that generally applies to interest received by companies in the relevant territory from an outside source. There is an exception where the interest is paid to such a company in connection with a trade or business carried out in Ireland.

*“Interest paid by an Irish company to a nonresident of Ireland is subject to interest withholding tax, currently imposed at the rate of 20%.”*

## TREATY NETWORK

Ireland has signed double taxation agreements with 76 jurisdictions, listed below, 74 of which are currently in effect (*i.e.*, excluding Ghana and Kenya).

|                      |            |             |                      |
|----------------------|------------|-------------|----------------------|
| Albania              | Ethiopia   | Lithuania   | Saudi Arabia         |
| Armenia              | Finland    | Luxembourg  | Serbia               |
| Australia            | France     | Macedonia   | Singapore            |
| Austria              | Georgia    | Malaysia    | Slovakia             |
| Bahrain              | Germany    | Malta       | Slovenia             |
| Belarus              | Ghana      | Mexico      | South Africa         |
| Belgium              | Greece     | Moldova     | South Korea          |
| Bosnia & Herzegovina | Hong Kong  | Montenegro  | Spain                |
| Botswana             | Hungary    | Morocco     | Sweden               |
| Bulgaria             | Iceland    | Netherlands | Switzerland          |
| Canada               | India      | New Zealand | Thailand             |
| Chile                | Israel     | Norway      | Turkey               |
| China                | Italy      | Pakistan    | Ukraine              |
| Croatia              | Japan      | Panama      | United Arab Emirates |
| Cyprus               | Kazakhstan | Poland      | United Kingdom       |
| Czech Republic       | Kenya      | Portugal    | United States        |
| Denmark              | Kosovo     | Qatar       | Uzbekistan           |
| Egypt                | Kuwait     | Romania     | Vietnam              |
| Estonia              | Latvia     | Russia      | 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.<sup>3</sup>

## CAPITAL DUTY

Capital duty is not 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, or the transfer of shares that are listed on a recognized stock exchange in the U.S.A or Canada, through a system operated by a central securities depository. This duty is only an unavoidable cost where the Irish holding company is also the ultimate parent 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 BY THE HOLDING COMPANY

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).

## C.F.C., THIN CAPITALIZATION, AND TRANSFER PRICING RULES

Pursuant to FA 2018, Ireland introduced controlled foreign corporation ("C.F.C.") rules. The rules apply for accounting periods beginning on or after January 1, 2019. C.F.C. rules are an anti-abuse measure targeted at the diversion of profits to offshore entities in low or no tax jurisdictions. The basic premise of C.F.C. rules is to attribute certain undistributed income of the offshore entity to its controlling parent and taxing same. Broadly, an entity will be a C.F.C. where it is (i) subject to more than 50% control by a parent company and its associated enterprises and (ii) tax on its profits account for less than half the tax that would have been paid had the income been taxed in the parent company's country of tax residence.

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<sup>3</sup> See **Dividends Received by Irish Companies**, above, regarding tax credits for foreign dividends.

The C.F.C. regime applies to Irish tax on income of foreign resident companies where certain activities are performed in Ireland by a company that controls the C.F.C.

A.T.A.D. allows Member States to determine whether the income of a C.F.C. should be attributed to its parent using one of two options. Ireland has opted for option B. Option B attributes undistributed income arising from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage. It focuses on bringing the income that is artificially diverted from Ireland to a low tax jurisdiction back into the Irish tax net.

There are a number of exclusions from the scope of the C.F.C. charge. For example, the C.F.C. charge does not apply where securing a tax advantage was not the essential purpose of the arrangement giving rise to the C.F.C.'s income or where the C.F.C. has profits of less than €75,000 or low value activities. Certain of these exclusions will not apply for an accounting period of a C.F.C. when the C.F.C. is resident in a noncooperative jurisdiction.

Apart from the recharacterization rules under which interest may be treated as a dividend, and certain anti-avoidance provisions restricting interest deductibility in certain intragroup debt scenarios, Ireland does not have thin capitalization rules.

## TRANSFER PRICING

In 2019, Ireland revised its transfer pricing rules to bring the rules in line with the 2017 O.E.C.D. Transfer Pricing Guidelines (the “2017 Guidelines”). The new rules take effect for accounting periods beginning on or after January 1, 2020 and provide that arm’s length nature of a price will be determined in accordance with the 2017 Guidelines. In addition, the changes mean that Irish transfer pricing rules now apply to certain non-trading transactions, certain larger capital transactions and to previously grandfathered transactions that were agreed prior to July 1, 2010. A further revision, introduced under Finance Act 2021 and applying to chargeable periods commencing on or after January 1, 2022, provides further detail as to the domestic non-trading transactions excluded from the scope of the Irish transfer pricing rules, and makes it clear that there does not need to be any consideration in order for the exemption to apply.

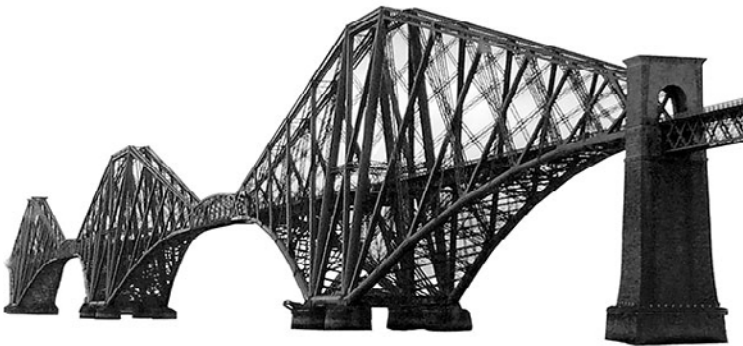
Subject to the execution of a Ministerial Order, Irish transfer pricing rules will also apply to transactions involving small and medium enterprises (“S.M.E.’s”). The change also brings in enhanced Irish transfer pricing documentation requirements in line with the 2017 Guidelines. Importantly, the rules also grant the Irish Revenue Commissioners the power to invoke a substance-over-form provision to disregard and recharacterize a transaction in certain circumstances.

## RELEVANT ANTI-AVOIDANCE PROVISIONS

Ireland has had a general anti-avoidance rule since 1989 but does not have any specific holding company 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 intermediate 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

### Author

Guillermo Canalejo Lasarte  
Uría Menéndez  
Madrid, Spain

### INTRODUCTION

A Spanish holding company, or “*entidad de tenencia de valores extranjeros*” (familiarily known by its Spanish acronym “E.T.V.E.”), is an ordinary Spanish company subject to 25% tax on its income. In relation to E.T.V.E.’s, as of January 1, 2021, the full exemption with respect to dividends and capital gains obtained from its subsidiaries has been reduced to a 95% exemption. In practice, this means that dividends and capital gains obtained by Spanish C.I.T. taxpayers, including E.T.V.E.’s,<sup>1</sup> would be taxed at an effective 1.25% tax rate (25% C.I.T. rate on the 5% of the registered dividends/capital gains).<sup>2</sup>

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 made free of Spanish withholding tax, unless the shareholder is resident in a noncooperative jurisdiction. This is subject to an anti-abuse rule discussed in **Exemption of E.T.V.E. Dividend Distributions**, regarding certain back-to-back 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 Spain’s 19% capital gains tax if the capital gains indirectly arise from an increase in value of the qualified foreign subsidiaries of the E.T.V.E., unless the shareholder is resident in a noncooperative jurisdiction.

Subject to the Anti-Tax Avoidance Directive (“A.T.A.D.”) of the E.U., E.T.V.E.’s are protected by E.U. directives such as the Parent-Subsidiary Directive (“P.S.D.”) and the Merger Directive, and are regarded as Spanish residents for tax purposes under Spain’s 95 bilateral tax treaties currently in force.

### INCOME TAX TREATIES

Listed below are the jurisdictions that have income tax treaties with Spain that are currently in force:

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<sup>1</sup> Either tax resident in Common Territory or the Basque Country or Navarra.

<sup>2</sup> The participation exemption regime will only apply in cases where the equity stake represents at least 5% in the relevant subsidiaries. The acquisition value of at least €20 million in cases where the minimum stake is not fulfilled will no longer be available for fiscal years starting on or after January 1, 2026 – after a five-year transitory regime applicable to subsidiaries held prior to January 1, 2021.

|                      |                    |             |                      |
|----------------------|--------------------|-------------|----------------------|
| Albania              | Czech Republic     | Kyrgyzstan  | Saudi Arabia         |
| Algeria              | Dominican Republic | Latvia      | Senegal              |
| Andorra              | Ecuador            | Lithuania   | Serbia               |
| Argentina            | Egypt              | Luxembourg  | Singapore            |
| Armenia              | El Salvador        | Macedonia   | Slovakia             |
| Australia            | Estonia            | Malaysia    | Slovenia             |
| Austria              | Finland            | Malta       | South Africa         |
| Azerbaijan           | France             | Mexico      | South Korea          |
| Barbados             | Georgia            | Moldova     | Sweden               |
| Belarus              | Germany            | Morocco     | Switzerland          |
| Belgium              | Greece             | Netherlands | Tajikistan           |
| Bolivia              | Hong Kong          | New Zealand | Thailand             |
| Bosnia & Herzegovina | Hungary            | Nigeria     | Trinidad & Tobago    |
| Brazil               | Iceland            | Norway      | Tunisia              |
| Bulgaria             | India              | Oman        | Turkey               |
| Canada               | Indonesia          | Pakistan    | Ukraine              |
| Cape Verde           | Iran               | Panama      | United Arab Emirates |
| Chile                | Ireland            | Philippines | United Kingdom       |
| China                | Israel             | Poland      | United States        |
| Colombia             | Italy              | Portugal    | Uruguay              |
| Costa Rica           | Jamaica            | Qatar       | Uzbekistan           |
| Croatia              | Japan              | Romania     | Venezuela            |
| Cuba                 | Kazakhstan         | Qatar       | Vietnam              |
| Cyprus               | Kuwait             | Russia      |                      |

Spain's extensive tax treaty network with Latin American countries, 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 E.U. capital investments, subject, of course, to the limitations of the P.S.D. when the principal shareholder of the E.T.V.E. is based outside the E.U.

Spain has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("M.L.I."). At the time of signing, Spain submitted a list of 86 tax treaties entered into by Spain and designated as Covered Tax Agreements ("C.T.A.'s"), *i.e.*, tax treaties to be amended through the M.L.I. Together with the list of C.T.A.'s, Spain also submitted a provisional list of reservations and notifications ("M.L.I. Positions") regarding various provisions of the M.L.I. The definitive M.L.I. Positions were provided with the deposit of Spain's instrument of ratification, acceptance, or approval of the M.L.I.

On September 28, 2021, Spain deposited its instrument of ratification of the M.L.I. (signed June 7, 2017), and it came into force on January 1, 2022. The provisions of the M.L.I. with respect to C.T.A.'s will come into effect after both Spain and the other party to the relevant C.T.A. have deposited instruments of ratification, acceptance, or approval of the M.L.I. and the specified time for the relevant provisions has passed.

## EXEMPTION ON QUALIFIED DOMESTIC AND 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 95% exempt from Spanish corporation income tax (“C.I.T.”).

The 95% 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. In general, the effective 1.25% tax cost is not eliminated for dividends distributed within a Spanish C.I.T. group. Nonetheless, the limitation on the participation exemption regime does not apply to dividends when the following circumstances occur cumulatively:

- The entity distributing the dividend was incorporated on or after January 1, 2021.
- Dividends are received in the first three years following the year of incorporation of the entity making the distribution.
- The entity receiving the dividend meets all of the following requirements:
  - Its net revenue in the previous period does not exceed €40 million.
  - It is not considered a passive-asset-holding company (*entidad patrimonial*).
  - It does not form part of a group of companies in accordance with Article 42 of the Spanish Commercial Code prior to the incorporation of the entity making the distribution.
  - It does not hold a significant stake in another company prior to the incorporation of the entity that distributes the dividend.

## QUALIFIED DOMESTIC AND FOREIGN INVESTMENTS

According to Articles 108 and 21 of the C.I.T. Law, dividends and capital gains received by an E.T.V.E. from domestic and nonresident subsidiaries are 95% exempt from Spanish taxation if the following requirements are met:

- The E.T.V.E. directly or indirectly holds a minimum 5% stake in the equity of the subsidiary (and any second-tier subsidiary).
- The E.T.V.E. directly or indirectly holds the minimum stake in the subsidiary and any second level subsidiary for at least one year, which in the case of dividends may be completed thereafter.
- The nonresident subsidiary is subject to, and not exempt from, a tax similar in nature to Spanish C.I.T. with a minimum 10% nominal income tax rate. In applying this test, it does not matter that an exemption, deduction, or other tax advantage applies to reduce the effective tax rate. Alternatively, the test is met if the foreign subsidiary benefits from an income tax treaty entered

into by its country of residence and Spain, provided that it is not resident in a noncooperative jurisdiction.<sup>3</sup>

### **Minimum Stake and Holding Period**

The 5% stake requirement must be met by the E.T.V.E. on the direct and indirect holding of any subsidiary. In certain circumstances, if a direct or indirect subsidiary obtains more than 70% of its income from dividends, rights to share in profits, or the transfer of shares in other entities, the E.T.V.E. must indirectly hold at least 5% of the share capital in all lower-tier subsidiaries.<sup>4</sup>

The E.T.V.E. must hold the stake in the subsidiary, whether directly or indirectly, for at least one year.<sup>5</sup> In the case of dividends, this minimum holding period requirement need not be met on the day dividends are distributed. Rather the one-year period can be completed after the distribution date. However, Spanish tentative tax will be levied upon receipt of the distribution, and a refund can be claimed when the one-year holding period has been fulfilled. In the case of capital gains, the minimum stake and minimum holding period requirements must be fulfilled on the date the capital gain transaction takes place.

### **Subject to and Not Exempt from Tax**

Nonresident subsidiaries must be subject to and not exempt from a tax of a nature similar to Spanish C.I.T., with a nominal tax rate of at least 10%, regardless of the application of any exemption, reduction, deduction, or other tax advantage.

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 nonresident subsidiary resides in a tax-treaty country, provided the treaty contains an exchange of information clause. The Spanish General Directorate of Taxation ("G.D.T.") has recognized that the minimum taxation requirement operates automatically.

Finally, nonresident subsidiaries located in one of the noncooperative jurisdictions defined below do not qualify for the E.T.V.E. tax exemption regime.



<sup>3</sup> Significant changes to the former Spanish list of tax haven jurisdictions have been introduced to align with O.E.C.D. and E.U. guidelines and, as a result of such amendment, from July 11, 2021, the term tax haven was replaced by "noncooperative jurisdiction." The concept expands the previous notion of a tax haven to include not only states and territories, but also preferential tax regimes. The Ministerial Order entered into force on February 11, 2023 (or on August 11, 2023 for specific countries or territories).

<sup>4</sup> For instance, companies within the same group that submit consolidated financial statements, or cases in which dividends or profits have been subject to taxation without being entitled to the exemption or double-taxation deduction, are excluded from complying with this requirement.

<sup>5</sup> For the purpose of calculating this period, the period in which the shares have been held by other entities within the same group, under the meaning of Article 42 of the Spanish Commercial Code, shall also be taken into account.

The traditional concept of “tax havens” established by Royal Decree 1080/1991 has been extensively reformed and, ultimately, replaced by “noncooperative jurisdictions” according to the First Additional Provision of Law 36/2006, of November 29, on prevention measures and actions against tax fraud, as amended through Spanish Law 11/2021 of July 9 and Order HFP/115/2023, of February 9. The amendment sought to introduce a “dynamic perspective” pursuant to which the corresponding Spanish authorities could more easily determine those countries or territories that are regarded as noncooperative jurisdictions based on, roughly speaking, the following criteria:

- **Tax transparency.** The country or territory does not have an in-force tax information exchange agreement with Spain, or the country or territory is not fulfilling an effective exchange of tax information with Spain.
- **Existence of mechanisms to erode the taxable base.** For instance, the domestic law of the country or territory permits offshore instruments or entities that may attract profits or revenues that do not reflect real economic activities.
- **Taxation threshold.** The domestic law of the country or territory does not establish taxes or regulations analogous to Spanish personal income tax, Spanish corporate income tax, or Spanish nonresident income tax regulations that ensure minimum taxation.

On February 9, 2023, almost two years after the ratification of Law 11/2021 and a few days before the approval of the revised “E.U. list” of noncooperative jurisdictions for tax purposes by the Council of the European Union, the Spanish government finally published regulations (in the form of a Ministerial Order) that, taking into consideration the above criteria, have replaced the original list with a new “catalogue” of the countries and territories (and harmful tax regimes) considered to be noncooperative jurisdictions. The Ministerial Order entered into force on February 11, 2023 (or August 11, 2023 for specific countries and territories as explained below). In particular, the new list, which differs from the revised “E.U. list” subsequently approved by the Council of the European Union, is as follows:

|                        |                  |                     |
|------------------------|------------------|---------------------|
| Anguilla               | Falkland Islands | Samoa               |
| Barbados               | Fiji             | American Samoa      |
| Bermuda                | Gibraltar        | Seychelles          |
| British Virgin Islands | Guam             | Vanuatu             |
| Cayman Islands         | Isle of Man      | Solomon Islands     |
| Dominica               | Bahrain          | Trinidad & Tobago   |
| Guernsey               | Marianas Islands | Turks & Caicos      |
| Jersey                 | Palau            | U.S. Virgin Islands |

A company formed in any of the foregoing jurisdictions may allow a Spanish stakeholder to benefit from the E.T.V.E. regime in either of two fact patterns. The first is that a nonresident subsidiary is resident in a Member State of the European Union or European Economic Area and the E.T.V.E. can demonstrate to the Spanish tax authorities that (i) the incorporation and operations of the nonresident subsidiary are carried out for valid economic reasons and (ii) the nonresident subsidiary is engaged in economic activities. The second is that the relevant country or territory

has entered into an exchange of information treaty with Spain or has entered into a tax treaty with Spain that contains an exchange of information clause. If either such treaty has been entered into, the country or territory will immediately cease to be considered a noncooperative jurisdiction, unless such country is added to the list by decision of the Spanish tax authorities.

### **Economic Activity Carried Out by the Nonresident Subsidiary**

In addition to the above requirements, the exemption for capital gains arising from the transfer of shares is conditional on the finding that the nonresident subsidiary carried out an economic activity and was not a holding company for passive assets (entidad patrimonial), an Economic Interest Group, or an entity for which the Spanish C.F.C. regime applies for Spanish resident shareholders. For this purpose, according to Article 5.2 of the C.I.T, a subsidiary is considered a passive-asset holding company if more than 50% of its assets are securities or the company is not engaged in a business activity. Under C.I.T. Law, a company's business activity is defined as the organization on its own account of material and human resources for the purposes of taking part in the supply of goods and services.

The Spanish C.F.C. regime is applicable where two conditions are met. The first is that the Spanish resident shareholder's stake in the subsidiary exceeds 50% of the share capital, equity, profits, or voting rights of the company. The second is that the income of the nonresident entity is taxed under a regime that is identical or similar in nature to the Spanish C.I.T. at a rate that is less than 75% of the Spanish C.I.T. rate.

## **QUALIFIED HOLDING COMPANY**

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

- Its corporate purpose must include the management and administration of nonresident entities. The E.T.V.E. may also carry out activities in Spain or in other jurisdictions in addition to the management and administration of nonresident entities, but those activities will not be covered by the E.T.V.E. regime.
- It must have sufficient material and human resources to manage the company. The G.D.T. has also repeatedly stated that an E.T.V.E. has an appropriate level of material and human resources when at least one of the members of the board of directors of the Spanish-resident company is in charge of the day-to-day management of the E.T.V.E. This condition is met if the director is responsible for preparing and keeping the E.T.V.E.'s accounts, preparing and filing periodic tax returns, bank account movements, issuing payment orders for both running costs (salaries, notary, and registration fees, etc.) and particular disbursements (additional investments of funds in subsidiaries, orders for distribution of dividends to shareholders, etc.).
- The securities that represent its share capital must be nominative.
- It must inform the Spanish authorities that it has opted to be subject to the provisions of the Spanish E.T.V.E. regime. The tax regime will apply to the first tax period ending after the notification is received and all successive periods until notice of termination is given to the Spanish tax authorities.

*“The Spanish C.F.C. regime is applicable where two conditions are met . . .”*

## DEDUCTION OF COSTS

The value of a stake in 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 limits on the deduction of financial expenses, as explained in **Corporation Income Tax** regarding the interest barrier rule.

## CAPITAL LOSSES

A capital loss realized upon the transfer of the shares of a domestic or nonresident subsidiary is not deductible where (i) the requirements set out in **Qualified Domestic and Foreign Investments** relating to qualified domestic and foreign investments above are met or (ii) the nonresident subsidiary is neither a resident of a tax treaty jurisdiction nor subject to a nominal income tax rate of at least 10%. Exceptions are provided for losses that arise as a result of the liquidation or termination of the subsidiary in a transaction that is not part of an internal corporate restructuring.

## LIQUIDATION LOSSES

Subject to certain limitations, a loss realized upon the liquidation of a nonresident subsidiary is deductible, unless it is liquidated as a result of an internal restructuring transaction. In that case, capital losses are reduced in the amount of the dividends received from the nonresident subsidiary during the 10-year period that precedes the dissolution date, provided that such dividends (i) have not reduced the acquisition value of the equity participation and (ii) qualified for an exemption or deduction regime.

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

Dividends distributed by an 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 Spanish withholding tax unless the shareholder is resident in noncooperative jurisdiction. Dividends distributed by an E.T.V.E. out of non-exempt income will be subject to the standard 19% withholding tax or the reduced bilateral tax treaty rate, as applicable.

Note that dividends paid by an E.T.V.E. to its E.U.-resident shareholder or to shareholders with residence in the European Economic Area (“E.E.A.”) will be exempt from Spanish withholding tax, provided the shareholder meets all the following conditions:

- It takes one of the forms set out in the Annex to the P.S.D.
- It is subject to, and not exempt from, tax as listed in Article 2(c) of the P.S.D.
- The dividend distribution does not proceed from the liquidation of the E.T.V.E.

- It owns directly at least 5% of the share capital of the E.T.V.E.
- It has held the stake for at least one year immediately preceding the dividend payment, or continues to hold the participation until the one-year period is completed.<sup>6</sup>

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 or E.E.A. Member State. Here, again, an exception may apply if the incorporation and operations of the shareholder are justified by valid economic motives and substantive business reasons.

In addition, several binding rulings issued by the Spanish tax authorities have held that exempt income earned through an E.T.V.E.'s foreign permanent establishment are properly treated as qualified exempt income of the E.T.V.E. when distributed in the form of dividends to a nonresident shareholder or realized as capital gains by a nonresident shareholder. Hence, such dividends and gains would not be taxed in Spain when received or realized by a nonresident shareholder.

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

Capital gains realized by nonresident shareholders on the disposal of Spanish shares are normally subject to a 19% tax. However, several exemptions may be available to nonresident shareholders on gains resulting from the disposal of shares in an E.T.V.E.

The first exemption is provided under domestic Spanish law. As long as the shareholder is not resident in a noncooperative jurisdiction, capital gains realized by nonresident shareholders from the disposition of shares of an E.T.V.E. will not be subject to the Spanish capital gains tax to the extent that the capital gains are equivalent to (i) the existing reserves from qualified foreign-source exempt income of the Spanish holding company or (ii) the appreciation in value of its stake in foreign subsidiaries and the stake fulfills the requirements described above during the entire holding period.

The second exemption is provided under relevant income tax treaties. Capital gains on the disposal of shares in an E.T.V.E. will generally not be subject to Spanish taxation if an applicable income tax treaty provides for an exemption.

The third exemption relates to rules under Spanish domestic law that are enjoyed by E.U.- and E.E.A.-resident shareholders. The exemption applies if the following conditions are met:

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<sup>6</sup> In the latter case, a tentative withholding tax 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.





- The E.T.V.E.'s assets do not mainly consist, directly or indirectly, of Spanish real estate.<sup>7</sup>
- If the E.U. or E.E.A. transferor is an individual, the equity interest in the E.T.V.E. amounts to less than 25% of total equity at all times during the 12-month period preceding the disposal of the interest.
- If the E.U. or E.E.A. resident is an entity, the participation exemption requirements set out in Article 21 of the C.I.T. Law must be met with respect to the E.T.V.E.
- The gain is not obtained through a country or territory defined as a noncooperative jurisdiction, as discussed above.

## LIQUIDATION OF E.T.V.E.

The liquidation of an E.T.V.E. triggers recognition of capital gains not subject to withholding tax, but taxable, if at all, as described above in **Capital Gains on Transfer of E.T.V.E.**<sup>8</sup>

A liquidation will also trigger capital duty unless specific or special provisions apply. This is discussed below in **Corporation Income Tax**.

## OTHER INCOME TAX ISSUES

In recent years, the Spanish tax authorities have challenged tax deductions for interest expense claimed by Spanish-resident corporate taxpayers that participate in intragroup transactions involving the purchase of shares of one member of the group, from another member of the group, in a transaction that is funded by a loan from a third member of the group. The basic claim in those cases is that the intragroup transaction is tax abusive because it lacks 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 C.I.T. Law. For C.I.T. purposes, the Decree prohibits deductions for interest expenses on intragroup 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. The disallowance is not applicable when sound business reasons exist for the transaction.

Royal Decree-Law 12/2012 does not define sound business reasons. Nevertheless, the Royal Decree-Law states in its preamble that a group restructuring that is a direct consequence of an acquisition by third parties and that could include specific

<sup>7</sup> This exception does not apply when the disposing shareholder is a Spanish resident corporation subject to C.I.T. In that context, the different tax treatment applicable to investments in Spanish property-rich companies by Spanish-resident entities and entities resident in a E.U./E.E.A. Member State should be deemed an unjustified infringement of the E.U. principle of free movement of capital and freedom of establishment.

<sup>8</sup> However, according to a recent ruling from the Spanish tax authorities, should the U.S.-Spain Tax Treaty apply to the liquidation, then the liquidation proceeds should be taxed as dividend income.

debt push downs and situations in which the acquired companies are in fact managed from Spain can be deemed reasonable from an economic perspective. The preamble is silent when the acquired companies are managed outside Spain.

## CORPORATION INCOME TAX

### **Rate**

An E.T.V.E. is subject to the 25% C.I.T. on income other than qualified dividends and capital gains.

For tax periods beginning on or after January 1, 2022, a minimum 15% C.I.T. rate over the taxable base was introduced for taxpayers (i) with a net turnover of at least €20 million in the preceding 12 months or (ii) that are taxed under the C.I.T. consolidation regime, regardless of their net turnover amount.

This minimum 15% C.I.T. rate

- is increased to 18% for entities involved in hydrocarbon research and exploitation and credit institutions — for which the general C.I.T. rate is 30% — or reduced to 10% for newly created entities — for which the general C.I.T. rate is 15%;
- does not affect certain entities subject to 10%, 1% or 0% C.I.T. rates, as applicable (e.g., investment funds and S.I.C.A.V.'s); or
- entities taxed under the S.O.C.I.M.I. regime.

For tax periods beginning on or after January 1, 2023, the Spanish government released the General State Budget Bill for fiscal year 2023. The bill reduces the tax rate from 25% to 23% for C.I.T. taxpayers with a net turnover below €1 million in the previous tax period, excluding entities forming part of a mercantile group and passive asset holding companies (*entidades patrimoniales*).

Moreover, the Start-Ups Law (Law 28/2022 of December 21) introduces a 15% C.I.T. rate for start-ups which applies to the first tax year in which taxable profits are earned and the following three tax years, provided the start-up qualification is maintained. The law also provides a deferral of C.I.T. debt for the first two years in which tax base is positive (12 months for the first period and six months for the second) with no need to provide a guarantee. During these periods, start-ups are exempt from making instalment payments on of C.I.T.

### **Interest Barrier Rule**

Royal Decree-Law 12/2012 has replaced the thin capitalization rules with a general restriction on the deduction of interest expense. The scope of thin capitalization rules was limited in cross-border transactions because they did not apply to interest on borrowings from residents in the E.U. Subject to specific adjustments, Royal Decree-Law 12/2012 provides that net interest expense exceeding 30% of the operating profit for a given tax year is not deductible for C.I.T. purposes. Interest expense 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.

For tax periods beginning on or after January 1, 2024, Law 13/2023 of May 24 has established that (i) operating profit should not include any income, expense, or rent which has not been included in the C.I.T. taxable base; and (ii) the interest barrier rule shall also apply to Spanish securitization funds. Prior to January 1, 2024, the general restriction on the deduction of net interest expense did not apply to the Spanish securitization funds, pursuant to Article 16.6 of the C.I.T. law.

In addition, Law 27/2014 of November 27, 2014, introduced limits on interest expense deductions arising from leveraged buyouts. The deduction is limited to 30% of the acquiring company's E.B.I.T.D.A. or €1.0 million, if greater. When computing the E.B.I.T.D.A. base, E.B.I.T.D.A. is ignored when attributable 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 limitation does not apply when the acquisition loan represents not more than 70% of the acquisition price and the principal of the loan is amortized fully over an eight-year period in equal installments.

### **Tax Consolidation Group**

Group companies can elect to adopt the special Tax Consolidated Group Regime. To make the election, the controlling company must directly or indirectly hold at least 75%<sup>9</sup> of the share capital of the subsidiaries on the first day of the fiscal period in which the regime is applicable and the holding must be maintained throughout the entire fiscal period. The controlling company must not be a subsidiary of any other entity deemed to be a controlling company or subject to one of the special tax systems described above. An exception exists allowing for a Spanish permanent establishment registered as a legal branch to become a controlling shareholder as long as its nonresident entity is resident in a country with which Spain has entered into a tax treaty with an exchange of information clause<sup>10</sup> and the shares of the Spanish subsidiaries are allocated to the legal branch.

The C.I.T. Law introduced an exception to the general scope of the special Tax Consolidated Group Regime which established that only Spanish-resident entities could form part of a consolidated group for tax purposes. From 2015 onwards, Spanish-resident entities directly or indirectly owned by the same nonresident parent company may be entitled to apply the consolidation regime if the parent is not resident in a noncooperative jurisdiction. The deemed Spanish parent company will be the Spanish-resident company that is appointed by the nonresident company that is the actual 75% shareholder. Spanish-resident entities include joint stock companies, limited liability companies, partnerships limited by shares, and any entity with a separate legal identity which is subject to and not exempt from Spanish corporate income tax.

Consolidated taxable income is determined by (i) totaling the taxable income of each group company (so positive and negative results are offset); (ii) eliminating profits and losses from transactions between group companies to the extent included in the taxable income of the entities forming part of the group (except intragroup dividends and capital gains);<sup>11</sup> and (iii) including prior-year eliminations when

<sup>9</sup> 70% if the subsidiaries are listed on a regulated stock exchange.

<sup>10</sup> All tax treaties entered into by Spain include an exchange of information clause.

<sup>11</sup> Intragroup dividends and capital gains should not be eliminated for tax consolidation purposes.

*“Group companies can elect to adopt the special Tax Consolidated Group Regime.”*

realized in subsequent years in transactions with third parties or when a company which carried out an intragroup transaction leaves the group. No withholding should be chargeable on payments made between entities of the tax consolidation group (interest, dividends, and rent for leases). The result is that net losses of group members may be used to offset income of other group members.

The use of losses in one company to offset profits in another company has been cut back by Law 38/2022. The group's taxable base for fiscal year 2023 will be calculated by offsetting (i) 100% of the combined income of companies reporting positive results with (ii) only 50% of the combined losses of companies reporting negative results.<sup>12</sup> The unused tax losses generated in 2023 will be included on a straight line basis over a 10-year period from 2024 (*i.e.*, years 2024-2033) without taking into consideration the limit of the cap described above.

The above integration may occur even if the entity generating the tax losses is dissolved at a later stage. However, the straight line integration over a 10-year period will not apply if the C.I.T. tax group is extinguished. In that case, the remaining tax losses are taken into account in the last tax period of the C.I.T. consolidation regime.

Net group tax losses can be carried forward against 70% of the taxable income following tax periods,<sup>13</sup> computed without taking into account any capitalization reserve, until fully utilized. A minimum of €1 million may be offset in all cases.

Group companies cannot carry forward losses on a separate company basis as long as they remain in the group. However, tax losses of a company arising prior to joining the group can be carried forward only against the income of that company.

### **Other Nondeductible Expenses**

Impairment allowances for share capital or equity investments in companies are generally not deductible under the C.I.T. However, impairment is deductible at the time of a transfer or disposal of the participation, provided the following requirements are met during the prior year:

- The participation is less than 5% of the total investment in the impaired company.
- In the case of participation in the capital of nonresident entities, the subsidiary (i) has been subjected to a foreign tax identical or analogous in nature to C.I.T. at a nominal rate of at least 10% or (ii) is resident in a country with which Spain has in effect an income tax treaty that contains an exchange of information clause. Again, all treaties of which Spain is a party contains an exchange of information clause.

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<sup>12</sup> The Spanish government had announced plans to extend the limits to the offsetting of C.I.T. tax losses in its proposal for the General State Budget Bill for fiscal year 2024, but there was no consensus for approval. It is likely that they will propose to extend the limit through other legislative measures.

<sup>13</sup> On January 18, 2024, the Spanish Constitutional Court issued Judgment 11/2024, declaring null and void certain measures approved by Royal Decree-Law 3/2016 of December 2, 2016, including (i) the limitation of the 70-50-25% tax loss carryforward, (ii) the limitation of the use of domestic and international double taxation credits for large taxpayers to 50% of the gross tax payable for the tax period, and (iii) the reversal of impairment losses of subsidiaries deducted prior to the 2013 tax period.

## **Payments on Account Against C.I.T.**

During the tax year, C.I.T. taxpayers are required to file three estimated tax payments for the current year. The payments must be made by the 20th day of April, October, and December.

Typically, an E.T.V.E. would not be required to make a tax payment relating to income that qualifies for the participation exemption. However, as a consequence of an amendment made in October 2016,<sup>14</sup> C.I.T. taxpayers with net turnover of €10 million or more, including dividends and capital, in the 12-month period preceding the first day of the tax period are obliged to make a minimum payment equivalent to 23% of the accounting result computed without taking into account tax exemptions or tax credits.<sup>15</sup>

As a result, an E.T.V.E. may be required to make a payment on account, which will eventually be refunded. There are certain options to minimize this financial cost, such as deferring the recognition of income by the E.T.V.E. until the last month of the taxable year, because the last month of the period is not covered by a payment on account.

## **Capital Duty**

The raising of capital by a Spanish company is exempt from capital duty. Likewise, the transfer to Spain of the seat of management of a foreign entity does not trigger capital duty. The reduction of share capital and the 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.

## **Transfer Pricing**

According to the C.I.T. Law, Spanish companies are required to enter transactions with related parties, as defined in Article 18.2 of the C.I.T. Law, on an arm's length basis. In accordance with the O.E.C.D. Guidelines, the comparable uncontrolled price method, the cost-plus method, the resale price method, the profit split method, or the transactional net margin method may be used to determine the arm's length value of a controlled transaction, with no preference given to any of the listed methods.

Additionally, the parties must produce and maintain appropriate documentation to demonstrate the basis for the valuation used. This obligation is not applicable principally for the following entities and transactions:



<sup>14</sup> Royal Decree Law 2/2016 of September 30, introducing tax measures intended to reduce the public deficit.

<sup>15</sup> The conformity of this amendment and minimum payment with constitutional principles is questionable and on March 6, 2024, the Superior Court of Justice in Valencia raised two questions regarding its unconstitutionality to the Spanish Constitutional Court (appeals number 1385/2022 and 1/2024, respectively).

- Transactions carried out between companies forming part of a tax consolidation group
- Transactions that an Economic Interest Group or Temporary Joint Venture (“U.T.E.”) carries out with its members or with other entities belonging to the same tax consolidation group. However, transactions with foreign permanent establishments are subject to documentation requirements
- Transactions carried out in the context of a takeover bid or a public stock offering
- Transactions with the same related individual or entity when the total market value does not exceed €250,000

The tax authorities are entitled to impose transfer pricing penalties for noncompliance in two situations. The first is when the taxpayer does not comply with its documentation obligations. The second is when the taxpayer complies with the documentation obligations, but the value of the transaction used by the taxpayer differs from the documentation provided to the authorities. Thus, if the valuation used in controlled transactions with related parties is consistent with the documentation provided to the authorities, even if the tax authorities disagree with the resulting valuation, no penalties will be imposed.

On February 19, 2024, the O.E.C.D. released the report on Amount B of Pillar One, which provides a simplified and streamlined approach to the application of the arm’s length principle to baseline marketing and distribution activities, with a particular focus on the needs of low-capacity countries.

For the taxable year beginning on January 1, 2016, Country-by-Country (“C-b-C”) reporting is required for operations of multinational groups based in Spain. These reporting requirements will apply also to a Spanish company that is a member of a foreign-based group when (i) its nonresident parent company is not required to file a C-b-C report in its country of tax residence and (ii) the foreign-based group has a consolidated annual turnover exceeding €750 million. Spanish entities have an obligation to file C-b-C reports within 12 months following the last date of the tax year.

Additionally, Spanish resident entities belonging to a group that is required to file C-b-C reports must notify the Spanish tax authorities prior to the close of the taxable year.

The C.I.T. Law allows a Spanish resident company to apply for a unilateral advance pricing agreement or “A.P.A.” The Spanish C.I.T. regulations detail the procedure for evaluating A.P.A.’s submitted 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 allow for an application requesting a bilateral advanced pricing agreement (“B.A.P.A.”) between the Spanish tax authorities, the tax authorities of the other country, the Spanish taxpayer, and its foreign affiliate.

Spanish tax authorities encourage taxpayers to submit A.P.A. proposals and recent experience is that they are flexible when evaluating proposals.

## **Controlled Foreign Corporations**

An E.T.V.E., like any other Spanish-resident company, is subject to C.F.C. rules, or the *transparencia fiscal internacional*. Under the C.F.C. rules, specific income generated by a foreign entity or foreign permanent establishment can give rise to C.I.T. for an 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 tax at an effective rate that is less than 75% of the rate under Spanish C.I.T. in comparable circumstances, and (iii) the income is tainted income. For this purpose, tainted income includes

- financial income;
- dividends;
- passive real estate income;
- royalties;
- sales and services provided to a related party in which the foreign entity or foreign permanent establishment adds little or no economic value;
- insurance;
- leasing financial activities; and
- other financial activities, regardless of whether the recipient is a Spanish tax resident.

In addition, if the conditions described in the first two bullets are met and the foreign entity or the foreign permanent establishment does not have the necessary human and material resources available to carry out its activity, all its income will be considered tainted.

An E.T.V.E. is not required to recognize tainted income obtained by its E.U. and E.E.A. affiliates to the extent that the E.T.V.E. can demonstrate to the Spanish tax authorities that the E.U. or E.E.A. affiliate is engaged in an active trade or business.

## **B.E.P.S.**

The C.I.T. Law that entered into force for tax periods beginning in 2015 introduced certain B.E.P.S.-inspired measures, mainly seeking to address hybrid instruments and payments. In particular, these measures are as follows:

- Interest on intragroup profit participation loans will be treated as equity instruments for tax purposes. The profit participation interest will no longer be tax deductible for the borrower and exempt for the Spanish-resident lender. The tax treatment for the non-Spanish resident lender remains unclear.
- Dividends received from foreign subsidiaries will not be entitled to the participation exemption to the extent that the dividend distribution has triggered a tax-deductible expense in the foreign subsidiary.

## **Transposition of the A.T.A.D. 2 (Hybrid Mismatches)**

For tax periods starting as of January 1, 2021, expenses incurred in cross-border transactions may not be tax deductible when part of a plan is designed to achieve a double no-taxation or double deduction tax result arising from differences existing between Spain and another jurisdiction (“hybrid mismatches”) in the legal characterization of a transaction.

The Spanish C.I.T. and N.R.I.T. laws now include detailed tax regulations on hybrid mismatches resulting from differences in the classification criteria applied across Member States. Article 15bis in the Spanish C.I.T. Law sets out the new regulations. Amendments have also been made to the N.R.I.T. Law (new points 6 and 7 to Article 18) to correct hybrid mismatches in the tax base of permanent establishments.

The purpose of the rules is to neutralize the tax effects of hybrid mismatches in related party transactions scenarios in which double nontaxation is achieved by means of double deduction, deduction without inclusion, and nontaxation without inclusion as a result of differences in the legal characterization of entities between jurisdictions. The implementation of A.T.A.D. II aims to prevent these scenarios in transactions between Spain and other Member States, as well as between Spain and other non-member states.

## **Pillar Two Global Minimum Tax Rules**

On December 15, 2022, the Council of the E.U. unanimously adopted the Pillar Two Directive ensuring a global minimum level of taxation for multinational enterprise (“M.N.E.”) groups and large-scale domestic groups in the E.U.

The Pillar Two Directive introduces a minimum effective tax rate for large multinationals with annual revenues of €750 million or more. It sets forth a system consisting of two interlocked rules – the Income Inclusion Rule (“I.I.R.”) and the Undertaxed Profit Rule (“U.T.P.R.”) – through which an additional amount of tax called a “top-up tax” should be collected any time the effective tax rate (“E.T.R.”) on the income of an M.N.E. group in a given jurisdiction is below 15%. In such cases, the jurisdiction is considered to be low-taxed.

Under this system, any parent entity of an M.N.E. group located in an E.U. Member State must pay an I.I.R. top-up tax to be calculated according to its allocable share in every entity of the group that is low-taxed (including itself), whether the entity is located within or outside the E.U.

For its part, the U.T.P.R. acts as a backstop to the I.I.R. and would, for example, apply in cases where the ultimate parent entity (“U.P.E.”) is located outside the E.U. in a jurisdiction that does not apply a qualifying I.I.R., or where such jurisdiction does apply a qualifying I.I.R. but the U.P.E. and its local subsidiaries are nonetheless low-taxed. The U.T.P.R. allocates any residual amount of top-up tax among constituent entities of the M.N.E. group located in jurisdictions that apply the U.T.P.R.

Member States may opt to apply a domestic top-up tax to constituent entities located in their territory. This election allows the top-up tax to be charged and collected in the Member State in which the low-level of taxation occurred, instead of collecting all the additional tax through the I.I.R. at the level of the U.P.E. or through the U.T.P.R. at the level of other group entities. When a Member State makes this election and





charges a domestic top-up accordingly, the amount of any top-up tax computed by another Member State is to be reduced by the amount of qualified domestic top-up tax.

E.U. Member States must transpose the provisions of the Pillar Two Directive into their national laws by December 31, 2023 so that they apply for fiscal years starting on or after December 31, 2023.

This means that the I.I.R. will be applicable in E.U. Member States for fiscal years starting on or after December 31, 2023. However, the Pillar Two Directive instructs that the U.T.P.R. should apply for fiscal years starting on or after December 31, 2024.

On December 20, 2023, the Spanish government published a draft bill (*anteproyecto*) transposing the Pillar Two Directive into its domestic legislation, which was sent to the Spanish Parliament for processing and approval. Therefore, as of June 2024, Spain has not effectively implemented the Pillar Two Directive and no tax legislation has been enacted or substantively enacted to adopt the rules.

In the meantime, the European Commission has opened infringement proceedings for late transposition of the Pillar Two Directive. Letters of Formal Notice have been sent to nine Member States – Estonia, Greece, Spain, Cyprus, Latvia, Lithuania, Malta, Poland and Portugal – which had not implemented national measures transposing the Directive into law by the deadline of December 31, 2023. This could lead the Commission to ask the Court of Justice of the European Union to impose financial penalties on these Member States.

### **The European Commission’s Directive Proposal on Fighting the Use of Shell Entities and Arrangements for Tax Purposes**

On December 22, 2021, the European Commission published proposal 2021/0434, which lays down rules for preventing the misuse of so-called shell entities for tax purposes and amends Directive 2011/16/EU (“Unshell Directive”).

Shell entities are companies and other entities which do not have substance and have minimal or no economic activity. They may be created and used for the sole purpose of obtaining tax advantages and attempting to avoid or evade taxes.

The main objective of the Unshell Directive is to prevent the misuse of shell entities for tax purposes by establishing criteria to identify entities that present a risk of not complying with minimum levels of economic substance – *i.e.*, a “substance test.” It also creates a reporting obligation for taxpayers and establishes negative tax consequences for entities considered to be shell entities.

The legislative procedure for the Unshell Directive remains ongoing and the provisions will be subject to additional discussion and potential amendments. Indeed, the E.U. Parliament ultimately approved an amended version of the Unshell Directive, the changes to which should not be considered as binding, but rather as recommendations. However, the E.U. Council will have the final say on the Unshell Directive’s adoption and its subsequent implementation into the domestic legislation of the E.U. Member States. There remains significant uncertainty regarding the directive’s final form, as E.U. Member States have not reached an agreement.

The Directive’s effective date will likely be deferred.

## **European Commission Publishes Draft Directive on Faster and Safer Relief of Excess Withholding Taxes (“FASTER”)**

On June 19, 2023, the Commission published a legislative proposal for a directive setting forth rules that aim to make withholding tax procedures in the E.U. more efficient and secure for investors, financial intermediaries, and Member States (the draft directive, also referred to as FASTER).

The fragmented framework of withholding procedures in the E.U. causes a number of obstacles for the investors and financial intermediaries involved. Obstacles exist due to, for example, burdensome procedures to relieve excess tax withholding at the source on dividends or interest. Withholdings procedures also pose risks of tax fraud and abuse.

FASTER prescribes the following key actions:

- A common E.U. digital tax residence certificate (for individuals and corporate entities) to be issued by the E.U. Member State of residence within 14 calendar days after a request is submitted
- A choice for E.U. Member States between a “relief at source” procedure and a “quick refund” system, or a combination of both, to be applied to withholding tax that a E.U. Member State can withhold on dividends from publicly-traded shares and, where applicable, interest from publicly-traded bonds
- A standardized reporting process that imposes common reporting obligations on certain financial intermediaries in the chain through a national register of certified financial intermediaries

E.U. Member States will then have until December 31, 2028 to transpose FASTER into national legislation, with the rules being applicable for fiscal years starting on or after January 1, 2030.

*“The fragmented framework of withholding procedures in the E.U. causes a number of obstacles for the investors and financial intermediaries involved.”*

## PORTUGAL

### Author

João Luís Araújo  
TELLES  
Porto, Portugal

Having gone through a very difficult economic period after the global financial crisis that started in 2007, Portugal has become an attractive investment destination for foreign investors and individuals.

Introduced in 2012, the non-habitual tax resident regime has attracted wealth, foreign companies, executives, and highly-qualified individuals to Portugal for more than ten years. However, as of the beginning of 2024, this regime has been revoked.

At more or less the same time, Portugal implemented a comprehensive set of tax reforms and other measures that were aimed at easing the way of doing business and making the country more attractive for investment:

- Corporate income tax reform was introduced in 2014 (Law No. 2/2014, of January 16).
- A new tax and legal framework were adopted in 2015 regarding collective investment vehicles (Decree-Law No. 7/2015, of January 13).
- The concept of Real Estate Investment Trusts (Decree-Law No. 19/2019, of January 28, 2019) was introduced.

Portugal's efforts in attracting investment have focused on the creation of a business-friendly environment that is designed to promote innovation and entrepreneurship. Portugal has emerged as an important platform for investment in the E.U. and in the Portuguese-speaking markets of Brazil, Angola, and Mozambique.

To that end, the following should be highlighted:

- The participation exemption regime
- The patent box regime
- Tax credits on R.&D. expenditure
- Tax credits on certain qualifying investment expenditure
- The tax consolidation regime
- No carryforward time limit for tax losses
- Tax deductions following certain capitalizations of companies
- Tax exemption or refunds for acquisitions of properties that are to be rehabilitated

The author acknowledges the contribution of Sara Brito Cardoso, an associate of TELLES.

- A reduced V.A.T. rate on property rehabilitations
- Special tax regimes applicable to certain investment vehicles, notably
  - real estate investment vehicles,
  - collective investment vehicles in movable assets, and
  - venture capital funds

Since January 1, 2023, the Portuguese patent box regime has become even more attractive. The current regime provides that only 15% of the profits on income related to the exploration or disposal of patents, industrial designs, or software is subject to corporate income tax.

The updated patent box, the S.I.F.I.D.E. tax credits (one of the benefits on R&D expenditure available), the financial incentives regime relating to R&D investments, and the Portugal 2030 Program make Portugal one of the most attractive countries in the world from which to carry out R&D activities.

Additionally, Portugal recently introduced a regime covering stock option plans by start-ups, micro, small, or medium-sized enterprises, small mid-caps, and companies that are active in the field of innovation. In brief, where the new regime applies, there will no longer be tax imposed at the time of exercise. Rather, tax is imposed only at the time of sale or the equivalent. Moreover, the sale will be treated as a capital transaction so that only one-half of the gain will be taxed when certain conditions are met. This potentially results in an effective tax rate of 14%.

The attractiveness of Portugal has also been boosted by the introduction of the new “Tech Visa” program. The main objective of this program is to expedite granting residence visas and residence permits to highly-qualified workers meeting certain legal requirements.

Alongside the revocation of the non-habitual resident regime at the beginning of 2024, a new regime with a similar outline was introduced. Its benefits are, in fact, potentially broader than those of its predecessor, mostly based on its focus on recruitment of professionals to take up positions in Portuguese companies in sectors such as R&D, exports, and start-ups.

In sum, Portugal has in place a competitive tax system and a business-friendly environment that not only attracts R&D activities and high-qualified individuals, and features a variety of legal forms and fund regimes that are suitable for holding, financing, and investing in securities and real estate.

## CORPORATE INCOME TAX SYSTEM

### **Overview**

Portugal has enacted a typical corporate income tax system that follows E.U. Directives.

Resident companies and nonresident companies maintaining a permanent establishment (“P.E.”) in Portugal are subject to a corporate income tax called “*Imposto sobre o Rendimento das Pessoas Coletivas*,” or “I.R.C.” and a state surcharge

("derrama estadual"). Regarding resident companies, the I.R.C. is levied on worldwide income, including capital gains, as set forth in Articles 4, 87 and 87-A of the Corporate Income Tax Code ("C.I.R.C."). Municipalities may also levy a municipal surcharge ("derrama municipal") on the annual taxable income of corporations.

A company is deemed resident in Portugal when its legal seat or place of effective management is located in Portugal. For this purpose, Portugal consists of mainland Portugal, the archipelagos of the Azores and Madeira, the respective territorial sea, and any area which, under international law, is under Portuguese jurisdiction.

The standard I.R.C. rate is 21%. As mentioned, a state surcharge may apply at the following progressive tax rates:

- 3% on income over €1.5 million
- 5% on income over €7.5 million
- 9% on income over €35 million

The law caps the municipal surcharge at a maximum rate of 1.5%, although exemptions or lower rates may be available depending on the specific rules of each municipality.

I.R.C. is charged on net taxable income, consisting of business/trading income, passive income, and capital gains. Generally speaking, only realized income and capital gains and losses are relevant for the computation of taxable income, although there are certain exceptions to this rule (namely related to financial instruments accounted for at fair market value). A foreign tax credit is allowed for the tax paid abroad.

The C.I.R.C. also provides a simplified tax regime for companies with taxable income of up to €200,000. Here, the taxable income simply is a percentage of the annual turnover, with the percentage varying based on the type of business that is conducted.

### **Deductible Expenses; Interest Limitation Rule**

As a general rule, duly documented expenses are tax deductible to the extent incurred for the purpose of the carrying on of the business activity.

Regarding interest expense deductions, Portugal imposes an interest expense limitation rule. The rule has been amended with the transposition of the Anti-Tax Avoidance Directive ("A.T.A.D.") adopted by the European Commission ("the Commission").

Companies may only deduct net interest expenses up to the higher of

- €1 million, and
- 30% of E.B.I.T.D.A.

This interest limitation rule applies to Portuguese tax resident companies and non-resident companies that maintain a P.E. in Portugal. Interest expenses that exceed the limit are not deductible, but may be carried forward and claimed as a deduction in the following five fiscal years to the extent available limitation exists.



The law provides several exclusions from the interest deduction limitation rule. The exclusion covers companies subject to the supervision of the Portuguese Central Bank or the Portuguese Insurance and Pension Fund Supervisory Authority. Also covered are Portuguese branches of other E.U. financial companies or insurance companies that are resident in a Member State of the E.U.

Securitization vehicles are also excluded from the interest limitation rule. However, in May 2020, the Commission notified Portugal that the exclusion for securitization companies does not qualify as “financial vehicles” under the A.T.A.D. Given that securitization vehicles are subject to strict regulation in Portugal and are under the supervision of the Portuguese Securities and Market Exchange Commission, the position of the Commission came as a surprise.

### **Permanent Establishments**

A fixed place of business in Portugal through which the business of a nonresident entity is wholly or partly carried on may result in the existence of a P.E. in Portugal. The C.I.R.C. defines a P.E. by reference to the standard examples of a physical premises through which business is carried on, including the following:

- A place of management
- A branch
- An office
- A factory
- A workshop
- A mine, an oil or gas well, a quarry or any other place of extraction of natural resources located in Portuguese territory
- A construction, installation or assembly site or yard, and the coordination, supervision and surveillance activities relating thereto, where the duration of such a site or yard or the duration of such activities last for more than six months
- The provision of services, including consultancy services, provided by a company, through its own employees or other persons contracted by the company to carry out such activities in Portuguese territory, provided that such activities are carried out during a period or periods that in total exceed 183 days in a 12-month period starting or ending in the tax period in question

Beginning in 2021, a P.E. is also considered to exist whenever a person, other than an independent agent, acts in the Portuguese territory on behalf of a company and (i) has, and habitually exercises, powers of intermediation and of concluding contracts binding the company, within the scope of its activities; (ii) habitually plays a determining role in the conclusion, by the company, of such contracts on a routine basis and without substantial changes; or (iii) keeps in Portuguese territory a deposit of goods or merchandise for delivery of such goods or merchandise on behalf of the company, even if the person does not habitually conclude contracts in respect to such goods or merchandise nor has any intervention in the conclusion of such contracts.

*“Securitization vehicles are also excluded from the interest limitation rule.”*

## **Group Consolidation**

A group consolidation regime<sup>1</sup> is available to affiliated companies when the parent company is a Portuguese tax resident or is a tax resident in another E.U. Member State. For group consolidation to apply, there must be a dominant company holding, directly or indirectly, at least 75% of the share capital of the subsidiaries and that holding must allow the dominant company to own at least 50% of the voting rights in the subsidiaries.

Once that hurdle is met, certain additional criteria must also be met:

- All group companies must be subject to tax and effectively managed in Portugal.
- The dominant company must hold the participation in the subsidiaries at least one year prior to the application of the regime.
- The dominant company cannot be controlled by another company that qualifies as a dominant company.
- The application of the regime has not been waived by the dominant company in any of the three years leading up to a new application of the group consolidation.

Where group consolidation applies, the tax group is not a taxpayer. Rather, each of the companies within the group remain autonomous taxpayers. Transactions between group companies are not disregarded for tax purposes. However, the taxable income of the group is computed by aggregating the taxable income and losses of all the group companies.

Tax losses incurred by a group member prior to entering the group are ringfenced and are available to offset income of that company only.

The group consolidation allows the interest expense limitation rules to be applied on a groupwide basis. Once group E.B.I.T.D.A. is determined, the cap applies to the aggregate interest expense of all members of the group.

## **Tax Neutrality Regime: Reorganizations / M&A**

The Portuguese C.I.R.C. provides for certain tax-free reorganizations under the tax neutrality regime. The Portuguese tax neutrality regime essentially mirrors the E.U. Merger Directive providing rollover relief for qualifying mergers, demergers, partial demergers and share-for-share exchanges of resident companies or companies resident in an E.U. Member State.

As is the case in other E.U. countries, the tax neutrality regime works by establishing that the acquisition date and the cost basis of the transferred shares or assets are carried over to the new holding. The transaction remains tax neutral even if cash payments are made to shareholders, provided that the cash amount does not exceed 10% of the nominal value of the transferred shares.

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<sup>1</sup> Called “*Regime Especial de Tributação de Grupos de Sociedades*,” R.E.T.G.S., which is provided in Articles 69 et. seq. of the C.I.R.C.

## **Standalone Taxation**

The Portuguese C.I.T. provides for standalone taxation for certain expenses, such as (i) unduly or undocumented expenses, (ii) general representation and entertainment expenses, (iii) mileage and per diem allowances, and (iv) payments made to residents in tax haven jurisdictions except where evidence exists that the payment relates to a genuine business expense and the amount is neither unusual nor excessive.

The tax is self-assessed and due even if no standard I.R.C. amount is payable.

## **Rulings**

The tax authorities usually provide general official rulings with their view and interpretation of specific provisions of a tax statute.

Taxpayers can also apply for an advanced ruling. In these rulings, the tax authorities issue their position regarding a particular situation, transaction, or operation under a description of facts presented by the taxpayer. Rulings are binding on the tax authorities only with regard to the taxpayer making the request and to the particular set of facts presented. They are not binding in matters related to other taxpayers or other sets of facts.

Advanced rulings are usually available for public consultation on an anonymous and factually sanitized basis. As in other countries, they provide useful guidance regarding the views that the tax authorities may take on similar transactions, even if the ruling is not binding on the tax authorities in matters pertaining to other taxpayers.

Finally, the law also provides for the possibility of advanced transfer pricing agreements.

## **Tax Arbitration**

Portuguese tax disputes are resolved in fairly complex legal proceedings with final resolution by the courts achieved only after many years of litigation. Settlement of the issue by agreement of the parties is not common.

In 2011, the government recognized the failings of the traditional dispute resolution mechanisms and introduced arbitration in tax matters. Tax arbitration and its legal regime were implemented by means of Decree-Law No. 10/2011, of 20 January, the “*Regime Jurídico de Arbitragem Tributária*” (“R.J.A.T.”), having the specific purpose of promoting faster resolution of tax disputes and reducing the backlog of pending tax cases in Portuguese courts. The Portuguese tax authorities are subject and bound by the decisions issued by tax arbitration panels (called tax arbitration courts or “*Tribunais Arbitrais*”) regarding disputes up to €10 million. Once tax arbitration procedures begin, the tax authorities cannot move the case to regular courts.

Tax arbitration has been implemented with great success and is usually highly regarded by taxpayers and legal professionals due to its efficiency and the quality of the arbitral decisions. Decisions are issued in six months, with the possibility of an extension of an additional six-month period. There is no requirement that arbitrators must be judges or former judges. The arbitrators may be former judges, but they also may be professors, authors, lawyers, tax consultants, economists, or former senior members of the tax authorities. To be eligible to be an arbitrator, an individual



*“ . . . the decision to move to tax arbitration should not be taken lightly but should be evaluated and reviewed carefully beforehand.”*

must have at least ten years of effective experience in tax matters and must be “of proven technical ability, having high moral standards and sense of public interest.”

In disputes up to €60,000, the tax arbitration courts work with a single arbitrator unless the taxpayer opts to appoint an arbitrator. Where that occurs, the tax authorities may also appoint an arbitrator, with a third arbitrator acting as chair and being chosen by the Administrative Arbitration Center (“*Centro de Arbitragem Administrativa*” or “C.A.A.D.”). In disputes above €60,000, the arbitration courts must consist of a panel of three arbitrators who are appointed by the C.A.A.D. unless the taxpayer elects to appoint one of the arbitrators. In that case, the tax authorities appoint a second arbitrator and the C.A.A.D. appoints the third arbitrator who serves as chair.

Once tax arbitration is elected, the opportunities to appeal from an adverse decision are restricted. Consequently, the decision to move to tax arbitration should not be taken lightly but should be evaluated and reviewed carefully beforehand.

## **PARTICIPATION EXEMPTION – RESIDENT HOLDING COMPANIES**

Portugal does not have in place a specific holding company regime. Nonetheless, the law provides for a participation exemption regime which was introduced by the 2014 corporate income taxation reform.

Under the participation regime, dividends received from qualified resident and non-resident subsidiaries and capital gains realized from the transfer of a participation in qualified resident and nonresident subsidiaries are exempt from I.R.C. To claim the benefit, the following requirements must be met:

- A 10% direct or indirect minimum participation (share capital or voting rights) must have been held continuously for at least one year prior to the distribution or sale. If a participation in a domestic or inbound subsidiary has been held for less than one year at the time of the distribution, the participation regime may still apply if the participation is retained until the one-year period has been met, by which time a refund for any taxes withheld by the distributing company should be requested. This exception to the one-year holding period obviously cannot apply to capital gains on the disposal of shares.
- The shareholder must not be a tax transparent company under the regime provided in Article 6 of the C.I.R.C. The Portuguese tax transparency regime is restricted to companies that are resident for tax purposes in Portugal, *i.e.*, companies set up under Portuguese law or effectively managed in Portugal.
- The company effecting the distribution must be subject to income tax and, if based outside the E.U., such tax should be imposed at a nominal tax rate of at least 12.6%, and must not be located in a tax haven jurisdiction. In this context, Portugal has an internal tax-haven list, that includes approximately 80 jurisdictions. This list is not aligned with other tax haven lists, such as the E.U. list.
- The capital gain does not relate to the sale of shares in a Portuguese real estate company, which is a company in which more than 50% of its asset value is attributable to real property in Portugal acquired on or after January 1, 2014. Real estate used for carrying on an agricultural, industrial, or

commercial activity (other than the purchase and sale of property) is not taken into account as Portuguese real estate for purposes of determining the status of the company. This exclusion covers real estate in the form of office buildings, hotels, lease arrangements, and land held for agricultural use.

Rules and exemptions regarding nonresident companies with subsidiaries in Portugal are discussed below in text related to nonresident companies.

## SPECIAL TAX REGIME APPLICABLE TO COLLECTIVE INVESTMENT VEHICLES

### General

Portugal provides an attractive tax regime applicable to collective investment vehicles. The regime was introduced by Decree-Law No. 7/2015, of January 13, and is construed as a tax incentive provided in Article 22 et. seq. of the Tax Incentives Statute.

Collective investment vehicles may be organized in fund or company form. They may also be open or closed, depending on whether the respective units are of a variable or a fixed number. Incorporation of a collective investment vehicle in Portugal is subject to prior authorization by the Securities and Exchange Commission.

The types of assets in which collective investment vehicles are able to invest will vary depending on the intended investments that will be made. Generally speaking, Securities Investment Funds and Companies are set-up for the purposes of investing in financial assets, whereas real estate investment companies are set up for the purposes of investing in real estate or related assets.

In April 2023, a new regulatory regime was introduced regarding collective investment vehicles. It introduced measures to simplify and speed up the setup of collective investment vehicles and management companies. Also, the types of investment vehicles have been simplified and significantly streamlined compared to prior legislation.

The collective investment vehicles tax regime provides for a typical exit taxation system, where taxation is shifted to investors. One of the main benefits of the regime is the fact that the vehicle itself, although subject to tax, can in practice be virtually exempt from I.R.C. because its most relevant income streams are excluded from taxation.

Portugal considers investment companies to be resident taxpayers that are subject to corporate tax in Portugal, albeit with an exclusion of certain income from the taxable base. Although open to question, it was the goal of the commission that introduced the regime that the collective investment vehicles would have access to Portugal's income tax treaty network and benefit from E.U. directives.

The taxable income of the vehicle reflects the net result of the period computed in accordance with generally accepted accounting standards applicable to collective investment vehicles. However, investment income such as dividends, interest, rental, or property income in the case of real estate investment companies, and capital gains realized from the disposal of investments are excluded from the tax base, unless the income is related to entities resident or domiciled in a tax haven jurisdiction.



The exclusion covers realized or potential income that reflects fair value accounting and forex gains and losses.

Some aspects of the standard I.R.C. regime remain applicable, such as standalone taxation on certain expenses, or the disallowance of expenses such as excessive, unrelated, or unsubstantiated expenses. Understandably, expenses incurred related to exempt income are not deductible. This covers items such as management fees.

To the extent that any taxable income arises, it would be subject to the standard corporate tax rate of 21%, but an exemption from the municipal and state surcharges would apply. Management companies are joint and severally liable for the tax obligations of the investment vehicle. Tax losses may be carried forward for five years. From January 1, 2023, there is no longer a maximum carry forward period.

The tax regime applicable to collective investment vehicles has, at the time of writing, not been updated to conform with the abovementioned recently enacted regulatory legislation.

### **Stamp Duty**

Portuguese-resident securities investment funds are subject to stamp duty that operates as a registration tax. The tax is levied quarterly on the funds' net asset value at the following rates:

- 0.0125% per quarter in the case of real estate investment companies
- 0.0025% per quarter in the case of securities investment funds investing in monetary instruments or deposits

In principle, collective investment vehicles are also subject to stamp duty charges on financial operations, such as the granting of credit and guarantees, as well as on interest and commissions charged by financial institutions, unless an exemption for some other reason is available. The tax authorities have issued a ruling (Ruling number 2018001066 of November 1, 2018) stating that collective investment vehicles are covered by the exemption from stamp duty on the use of credit, associated guarantees, interest and commissions charged by the credit institutions that qualify as financial institutions under E.U. law.

### **Compartments**

An interesting albeit not commonly used feature of the Portuguese Collective Investment Undertaking legislation is that a regulated company or fund may be divided in various separate compartments which can, within the same legal entity, fully segregate the assets and liabilities of each compartment and determine different distribution policies for the compartments. To the extent that a vehicle is divided into compartments, the rules apply to each of the compartments independently.

### **M&A Operations**

The general tax neutrality regime for M&A transactions may apply to collective investment vehicles. This is discussed in **Tax Neutrality Regime: Reorganizations / M&A**. Transactions not entitled to tax neutrality regime may be taxable on general terms.

## **Value Added Tax**

Collective Investment Vehicles are in principle taxable persons for V.A.T. purposes. However, their supplies are usually connected with financial operations, generally exempt from V.A.T. Notwithstanding recurring debates with the tax authorities on the V.A.T. impact on holding activities,<sup>2</sup> the exemption is not zero-rated. Therefore, it does not provide for the right to deduct the V.A.T. incurred in connection with expenses related to such income. Consequently, the V.A.T. borne by a collective investment vehicle constitutes an effective cost of the vehicle. This, however, should not be the case in relation to V.A.T. incurred on expenses connected with V.A.T. taxable activities performed by the vehicle.

## **Taxation of Income Obtained in Portugal by Other E.U. Member-States Resident Collective Investment Vehicles**

A strictly literal view of the wording of the regime may suggest that the tax incentives discussed above are not applicable to collective investment vehicles established outside Portugal. However, decisions from Tax Arbitration Courts in Portugal have addressed the potential discrimination against vehicles incorporated in other E.U. Member States. These cases addressed whether E.U. law is violated by the imposition of Portuguese withholding tax on dividends distributed by a Portuguese company (i) to a collective investment vehicle incorporated in another Member State and (ii) to a Portuguese branch of a collective investment vehicle incorporated in another Member State. In both decisions, the Tax Arbitration Courts ruled that the distinction between resident and nonresident collective investment vehicles violates the E.U. principle of free movement of capital.

These decisions do not constitute controlling precedent for other disputes. Nonetheless, the decisions suggest that tax arbitration panels would likely agree that Portuguese withholding tax should not be imposed on investment income, real estate income, and capital gains obtained in Portugal by a collective investment vehicle that is resident in a Member State of the E.U. or on comparable income received by a P.E. that is maintained in Portugal by a company that is resident in a Member State of the E.U.

In the majority of the decisions issued by Tax Arbitration Courts, the arbitration panel found that the violation of E.U. law was clear and therefore did not request preliminary rulings from the European Court of Justice (“E.C.J.”). However, an arbitration panel referred the question to the E.C.J. In March 2022, the E.C.J. ruled that legislation under which dividends distributed by resident companies to a nonresident collective investment vehicle are subject to withholding tax but dividends distributed to a resident collective investment vehicle are exempt from that tax is contrary to E.U. law,<sup>3</sup> case law which has been applied by the Tax Arbitration Courts ever since.

## **Taxation of the Investors**

As mentioned above, the Portuguese regime for collective investment vehicles excludes income derived from qualifying activities from the respective tax base. As

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<sup>2</sup> It is anticipated that this debate will disappear given the clear C.J.E.U. case law on the topic.

<sup>3</sup> *ALLIANZGI-FONDS AEVN v. Autoridade Tributária e Aduaneira* (Case No. C-545/19).

such, these vehicles typically pay little or no tax in Portugal, notwithstanding their *prima facie* taxable status. This benefit is offset at the time distributions are made to investors. Portuguese taxation in the form of a withholding tax is levied on distributions made by the collective investment vehicle to its investors. The Portuguese taxation on distributions will vary depending on the residence of the investor and its status as a corporation or an individual.

Individual investors are subject to tax on distributions and capital gains that are received from a collective investment vehicle. The personal income tax rate of 28% applies unless the participation relates to the business activity of the individual, where progressive tax rates of up to 48% apply plus a solidarity charge of 2.5% on income over €80,000 and 5% on income over €250,000. If an individual taxpayer elects for the aggregation of all investment income received in a given tax year, only 50% of the distributions is taken into account in computing taxable income. That amount is then subject to progressive tax rates.

Regarding resident corporate investors, it is open to question as to whether a tax exemption may apply under the participation exemption regime. If not, the relevant income is taxable on standard terms. In the case of real estate investment companies/funds, the Portuguese tax authorities have already issued their view that the Portuguese participation exemption regime cannot apply.

For nonresident investors, the Portuguese taxation will vary depending on the type of collective investment company that makes the distribution:

- Nonresident investors in real estate investment funds or real estate investment companies will be subject to tax on distributions made by the collective investment vehicle at a 10% flat rate.
- Income derived by nonresident participants (both companies and individuals) from securities investment funds and securities investment companies is, in principle, tax exempt in Portugal.

In any case, for the purpose of accessing the tax exemption or reduced withholding on distributions, nonresident investors must submit to the collective investment vehicle or management company adequate evidence of the nonresident status.

Some exceptions to the above apply. A nonresident corporation is not entitled to the exemption or reduction in tax if 25% or more of its shares is directly or indirectly held by individuals or companies resident in Portugal. However, the exemption may still apply if the nonresident company meets all the following conditions:

- It is resident in (i) an E.U. Member State, (ii) an E.E.A. member state that has entered into an administrative cooperation agreement in tax matters equivalent to the cooperation available among Member States of the E.U., or (iii) a state with which Portugal has in effect a treaty providing for the exchange of information in tax matters.
- It is subject to and not exempt from tax under the standard used in the Parent/Subsidiaries Directive, or to a tax similar to the Portuguese corporate income tax, and the applicable rate is not less than 12.6%.



- It has a direct or indirect 10% shareholding or ownership of voting rights in the Portuguese collective investment vehicle for an uninterrupted period of one year.
- The structure is not considered to be part of an artificial construction having as a main purpose the intent to obtain a tax advantage.

Another exception to favorable treatment applies to a nonresident participant based in a tax haven jurisdiction. When a distribution or a payment in redemption of units is made to that category of investor, the payment is subject to withholding tax of 35%. Capital gains from the sale of units in secondary markets by that category of investor will be subject to a 28% tax for an individual or a 25% tax for a corporation.

The final exception to the favorable treatment applies when the beneficial owner of the participant is not identified.

If the units are acquired on secondary markets, the acquisition price must be reported to the collective investment vehicle, the management company, or the custodian/depositary. If a taxable transaction is not reported, the tax is imposed on the gross transactional value rather than the actual gain.

### **Real Estate Investment Trusts**

The Real Estate Investment Trusts (“R.E.I.T.’s”) regime was approved by Decree-Law No. 19/2019, of January 28, 2019, and establishes a new mechanism to invest in real estate in Portugal. The principal benefit of the R.E.I.T. is the exemption from corporate income tax for capital income (interests and dividends), rents, capital gains, and commissions.

To be qualified as a R.E.I.T. the company must meet the following requirements:

- It must be incorporated as a public limited liability company (“*Sociedade Anónima*”) with a Supervisory Board and an Official Auditor. It is possible to convert an already existing public limited liability company or a collective investment vehicle into a R.E.I.T.
- It must have minimum share capital of €5 million that is subscribed, fully paid, and represented by a single class of common shares.
- It must meet certain thresholds on assets and debts.
- It must comply with specific requirements relating to the distribution of profits.
- Its company name must include the term “*Sociedade de Investimento e Gestão Imobiliária*, S.A.” or the term “S.I.G.I., S.A.”
- After the first year and up to the end of the third year of existence of the company, at least 20% of its shares must be listed and negotiated in a stock market or in a multilateral negotiation system. By the end of the fifth year, the minimum percentage of listed shares is increased to 25%.

In addition, the corporate purpose of the R.E.I.T. as inscribed in its articles of association must be limited to the following activities:

- The purchase of real estate, building or other property rights, leasing activities regarding the real estate, and other forms of real estate exploitation such

as leasing for commercial purposes or the development of real estate by means of new construction and rehabilitation projects

- Purchase of shares in other R.E.I.T.'s or shares of companies having a place of business based in the E.U. or the E.E.A., provided that (i) the corporate scope of the target entity is equivalent to that of a Portuguese R.E.I.T., (ii) the assets of the target entity comply with the thresholds established in the Portuguese legislation, (iii) the share capital of the target company includes nominal shares, and (iv) the target company's profit distribution policy is equivalent to the policy established in the Portuguese legislation
- Purchase of participation units or shares (i) in companies with a profit distribution policy identical to the R.E.I.T. or (ii) in companies involved in residential real property
- Purchase of participations in Leasing Real Estate Investment Funds or Residential Letting Real Estate Investment Companies

There is no limitation in terms of obtaining income from other activities, although the benefits resulting from this regime will be applicable only to the abovementioned activities.

The main tax benefit granted to R.E.I.T.'s is the exclusion from corporate income tax on investment income as described above. As with other collective investment vehicles, to the extent the income is excluded from tax, the related costs are not tax deductible.

The taxation of income obtained by investors in the R.E.I.T. follows in essence the regime outlined above in relation to other collective investment vehicles:

- Income derived from investments in corporate residents will be subject to the general rules applicable to other resident companies. As mentioned above, the tax authorities have already declared to find that the participation exemption regime may not apply on distributions and capital gains. Therefore, withholding tax is imposed at a 25% rate which may be due in advance of the final C.I.T.
- In the case of resident individual investors, the payment of a dividend from the R.E.I.T. will attract a final tax withholding of 28% except when the income is linked to the economic activity of the individual.
- Foreign investors will be subject to a 10% final withholding tax unless the investor is tax resident in a tax haven jurisdiction.

Because a R.E.I.T. is a corporate entity that is subject to I.R.C., the view in Portugal is that a Portuguese R.E.I.T. will be considered to be a tax resident in Portugal that is entitled to claim benefit under Portugal's treaty network and for the purposes of E.U. directives.

### **Venture Capital Funds**

For regulatory purposes, venture capital is defined as the acquisition and holding for a limited period of time of shares in companies with high growth potential. As a result, the activity of venture capital funds is generally limited to investment in venture capital as defined above. These companies cannot pursue other commercial

purposes, although they can pursue activities that are considered auxiliary to their main purpose. Examples are the performance of financial and administrative management services.

From a tax perspective, the income of venture capital funds (“V.C.F.’s”) incorporated and operating under the Portuguese legal regime is exempt from taxation. Moreover, the subscription of units in V.C.F.’s does not give rise to any tax charge.

The income obtained by investors who are resident for tax purposes in Portugal will be taxed as follows:

- Individuals or companies resident for tax purposes in Portugal will be subject to a 10% withholding tax on income paid by the V.C.F. and the income resulting from a redemption of units in the fund. Although the withholding tax applicable to distributions and redemptions is the same for investors that are resident companies and individuals, a significant difference exists in the nature of the withholding tax. For corporations, the withholding tax is considered to be a prepayment of the final corporate tax that will be due on total income for the entire tax year. Ordinary corporate tax rates will apply once the year’s income is computed. In comparison, the withholding tax for a resident individual is in the nature of a final tax. No further income tax is payable on that income.
- Companies that are resident in Portugal for tax purposes but tax exempt on capital gains will not be subject to withholding tax on income paid by the V.C.F. and on income from the redemption of units in the fund.
- Individuals that are resident in Portugal for tax purposes will be subject to a 10% tax rate on capital gains generated by the disposal of units in the fund.
- Companies that are resident in Portugal for tax purposes will be subject to the general corporate income tax regime on capital gains made on the disposal of participation units.

Nonresident companies are exempt from Portuguese tax on distributions from a V.C.F. and redemptions of units of a V.C.F. where the following two conditions are met:

- Portuguese resident companies do not hold 25% or more of the share capital of the nonresident company.
- The nonresident company is not resident for tax purposes in a blacklisted jurisdiction.

Income received or redemptions made by nonresident individuals are subject to a 10% withholding tax.

Regarding the capital gains generated on the disposal of units, nonresident investors will generally be exempt from taxation in Portugal. The exemption does not apply where more than 50% of the assets of the fund relate to Portuguese real estate or when the investor is resident in a blacklisted jurisdiction. When the exemption is inapplicable, a 10% tax rate on the gains made on the disposal of the units of such funds will be imposed.

*“Income received or redemptions made by nonresident individuals are subject to a 10% withholding tax.”*



Finally, nonresident investors will not be deemed to have a P.E. in Portugal as a result of holding units in the fund.

## NONRESIDENT COMPANIES

Nonresident companies are subject to I.R.C. on income deemed to have been obtained in Portugal.

In the 2014 corporate tax reform, Portugal introduced several tax measures aimed at attracting foreign investment. In broad terms they are aimed at (i) the elimination of withholding taxes on the payment of dividends, interest, and royalties and (ii) granting tax-free treatment for capital gains arising from the sale of shares and the sale of qualifying financial instruments.

### **Dividends**

Dividends paid by a Portuguese company to a nonresident holding company can be tax exempt provided that all the following criteria are met, and the nonresident company complies with certain formalities:

- The holding company is resident in an E.U. Member State, a qualifying state within the E.E.A., or a state which has entered into a double taxation agreement with Portugal providing for the exchange of information for tax purposes. It is understood that a company is tax resident in a given state if it does not qualify as tax resident in any other state under any of the double taxation treaties entered by that state.
- The holding company holds a direct or indirect participation of at least 10% of the share capital or the voting rights of the Portuguese company.
- The participation in the Portuguese company has been held for at least one uninterrupted year prior to the distribution.
- The holding company is subject to and not exempt from corporate income tax in its country of residence, and if based outside the E.U. or the E.E.A., at a nominal rate of at least 12.6%.
- An arrangement or series of arrangements are not deemed to have been put into place for the purpose of obtaining a tax advantage that defeats the object and the purpose of elimination of double taxation.

Where the abovementioned exemption from withholding tax does not apply, outbound dividend payments are usually subject to withholding tax imposed at a rate of 25%, unless a different rate is available under a relevant tax treaty.

### **Capital Gains**

Under the Tax Incentives Code, capital gains on the sale of shares and qualifying securities of Portuguese entities are exempt from tax when derived by qualifying nonresident companies that do not hold the qualifying assets through a P.E. in Portugal. To qualify for the capital gains exemption, the nonresident company must meet the following conditions:

- It cannot have a P.E. in Portugal, or if one exists, the P.E. cannot be involved in the sale of the assets.
- It cannot be a resident for tax purposes in a blacklisted jurisdiction.
- It cannot be more than 25% owned, directly or indirectly, by a Portuguese resident company or individual, unless
  - the seller is a resident of an E.U. Member State, a state within the E.E.A., or a state that has an income tax treaty in effect with Portugal that provides for the exchange of information for tax purposes;
  - the seller is subject to income tax and, if based outside the E.U., such tax is imposed at a nominal tax rate of at least 12.6%;
  - the seller has directly or indirectly held at least 10% of the share capital or voting rights of the company being sold for an uninterrupted period of at least one year prior to the sale; and
  - the sale must not form part of an arrangement put into place for the purpose of obtaining a tax advantage that defeats the object and the purpose of elimination of double taxation.

Even if the above conditions are met, this regime does not apply in certain circumstances. The first is that it does not apply to legal entities if, at any given time in the year prior to the sale, the company issuing the shares derives more than 50% of its value from real estate located in Portugal. The second is that it does not apply whenever the shares are sold by a foreign company in which more than 50% of its asset values are derived from real estate located in Portugal, directly or indirectly, in any given time in the year prior to the sale. Neither exception to the general rule applies where the immovable property is used for carrying out an agricultural, industrial, or commercial activity, other than the purchase and sale of real estate.

If the tax exemption does not apply, capital gains derived by nonresident companies without a P.E. in Portugal are subject to a flat 25% tax imposed on the gain, unless a lower rate is available under a relevant income tax treaty. However, if the company is tax resident in a blacklisted jurisdiction, the tax rate is increased to a 35% tax rate.

### **Interest and Royalties**

Following the transposition of the Interest and Royalties Directive (“I.R.D.”), interest or royalty payments to companies resident in an E.U. Member State or Switzerland are exempt from tax if the requirements set forth in the I.R.D. are fulfilled.

This exemption may be denied if the nonresident company does not have its Beneficial Ownership registration up to date or it reflects an arrangement or series of arrangements that have been put into place for the purposes of obtaining a tax advantage that defeats the object and the purpose of elimination of double taxation.

## **INCOME TAX TREATIES**

As of the date of this article, Portugal has in force and effect 78 treaties to avoid double taxation, as listed below:

|                |               |                   |                      |
|----------------|---------------|-------------------|----------------------|
| Algeria        | Ethiopia      | Macao             | Senegal              |
| Andorra        | France        | Malta             | Singapore            |
| Angola         | Georgia       | Mexico            | Slovakia             |
| Austria        | Germany       | Moldova           | Slovenia             |
| Bahrain        | Greece        | Montenegro        | South Africa         |
| Barbados       | Guinea-Bissau | Morocco           | South Korea          |
| Belgium        | Hong Kong     | Mozambique        | Spain                |
| Brazil         | Hungary       | Netherlands       | Switzerland          |
| Bulgaria       | Iceland       | Norway            | Timor-Leste          |
| Canada         | India         | Oman              | Tunisia              |
| Cape Verde     | Indonesia     | Pakistan          | Turkey               |
| Chile          | Ireland       | Panama            | Ukraine              |
| China          | Israel        | Peru              | United Arab Emirates |
| Colombia       | Italy         | Poland            | United Kingdom       |
| Croatia        | Ivory Coast   | Qatar             | United States        |
| Cuba           | Japan         | Romania           | Uruguay              |
| Cyprus         | Kuwait        | Russia            | Venezuela            |
| Czech Republic | Latvia        | San Marino        | Vietnam              |
| Denmark        | Lithuania     | São Tomé Príncipe |                      |
| Estonia        | Luxembourg    | Saudi Arabia      |                      |

## **M.L.I.**

Portugal signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the “M.L.I.”) June 7, 2017, having deposited the Instrument of Ratification on February 28, 2020. In respect to Portugal, the M.L.I. entered into force on June 1, 2020.

Regarding the M.L.I., listed below are several key reservations and notifications made by Portugal.

### **Transparent Companies**

Pursuant to Article 3(5)(a) of the M.L.I., Portugal reserved the right to refrain from applying the provision to its Covered Tax Agreements. Article 3 of the M.L.I. relates to hybrid mismatches. This policy statement was noted in the reservations made by Portugal to the Commentaries to the O.E.C.D. Model Convention and has been consistently applied by the Portuguese tax authorities in various rulings.

### **Dual Resident Companies**

Article 4 of the M.L.I. relates to dual resident companies. Pursuant to Article 4(3)(a) of the M.L.I., Portugal reserved the right for the entirety of Article 4 to opt out of the provision with regard to its Covered Tax Agreements.



## **Capital Gains from Alienation of Shares or Interests of Companies Deriving Their Value Principally From Immovable Property**

Article 9 deals with the taxation of gains from the sale of real property holding companies. Pursuant to Article 9(8) of the M.L.I., Portugal chose to apply Article 9(4). This provision is in line with Portugal's internal income tax legislation.

## **ANTI-AVOIDANCE MEASURES**

In various provisions of Portuguese tax law discussed above, several anti-avoidance and anti-abuse rules were discussed with regard to the claim of a specific benefit under domestic law. Here, we discuss rules that have broader application to domestic and international business transactions.

### **General Anti-Abuse Rule (“G.A.A.R.”)**

The Portuguese tax system has long contained a G.A.A.R.<sup>4</sup> provision. It has been adapted to be in line with the A.T.A.D.

Under the current version of the G.A.A.R., a transaction or set of transactions may be disregarded for tax purposes whenever it is proved that the main purpose, or one of their main purposes was obtaining a tax advantage that defeats the object or purpose of the law, namely avoiding tax that would otherwise be due.

Hence the application of the G.A.A.R usually involves the existence of wholly artificial arrangements, or arrangements with abuse of legal forms, put into place to reduce, eliminate, or defer the tax normally due or to obtain an undue tax advantage. Following A.T.A.D., the law clarifies that an arrangement is deemed artificial or non-genuine to the extent that it was put into place with no valid commercial reasons and does not reflect economic reality. The application of the G.A.A.R. implies that taxation should follow standard terms applicable to a particular business transaction and assumes that the parties will act in a way that reflects the true economic substance of the operation, with the removal of the undue tax advantages.

### **Controlled Foreign Company (“C.F.C.”) Rules**

The C.I.R.C. contained provisions relating to C.F.C. rules for many years. Again, those provisions were amended by the law transposing the A.T.A.D.

Under the current version of the C.F.C. rules, individuals and corporations that are tax resident in Portugal are subject to the C.F.C. provisions when holding directly, indirectly, or through a fiduciary or an agent, at least 25% of the shares, voting rights, profit rights, or assets of a nonresident entity that is subject to a low-tax or no-tax regime.

For a nonresident entity to be subject to a low-tax regime, at least one of the following tests must be met:

- The corporate income tax effectively paid abroad on the profits of the C.F.C. is less than 50% of the I.R.C. that would have been due under Portuguese corporate income tax rules.
- The jurisdiction where the C.F.C. is established is included in the Portuguese blacklist of low-taxed jurisdictions.

<sup>4</sup> Set forth in Article 38 of the General Tax Law.

*“The Portuguese tax system has long contained a G.A.A.R. provision. It has been adapted to be in line with the A.T.A.D.”*

However, the C.F.C. regime will not result in the imposition of tax on a Portuguese resident as long as the specified passive income amounts to less than 25% of total gross income of the C.F.C. The specified passive income categories are

- interest or any other income generated by financial assets;
- royalties or any other income generated from intellectual property, personality rights, and the like;
- dividends and income from the disposal of shares;
- income from financial leasing transactions;
- income from insurance, banking, and other financial activities; and
- income from re-invoicing companies that earn sales and services income from goods and services purchased from, and sold to, associated enterprises, and that add no or little economic value.

In respect to a foreign company resident in the E.U., the C.F.C. rules are not applicable as long as a certain level of substance, human capital, and material resources are present and contribute to the business activity.

### **Blacklist of Low-Taxed Jurisdictions**

Through various Orders,<sup>5</sup> the Portuguese government has adopted the following blacklist of low-taxed jurisdictions as of January 1, 2021.

|                        |                  |                      |                          |
|------------------------|------------------|----------------------|--------------------------|
| American Samoa         | Falkland Islands | Marshall Islands     | St. Helena               |
| Anguilla               | Fiji             | Mauritius            | St. Kitts & Nevis        |
| Antigua & Barbuda      | French Polynesia | Monaco               | St. Lucia                |
| Aruba                  | Gambia           | Montserrat           | St. Pierre & Miquelon    |
| Ascension Island       | Gibraltar        | Nauru                | St. Vincent & Grenadines |
| Bahamas                | Grenada          | Netherlands Antilles | Svalbard Islands         |
| Bahrain                | Guam             | Niue                 | Swaziland                |
| Barbados               | Guyana           | Norfolk Island       | Tokelau                  |
| Belize                 | Honduras         | N. Mariana Islands   | Tonga                    |
| Bermuda                | Hong Kong        | Oman                 | Trinidad & Tobago        |
| Bolivia                | Isle of Man      | Palau                | Tristan da Cunha         |
| Brunei                 | Jamaica          | Panama               | Turks & Caicos           |
| British Virgin Islands | Jordan           | Pitcairn Island      | Tuvalu                   |
| Cayman Islands         | Kiribati         | Puerto Rico          | United Arab Emirates     |
| Channel Islands        | Kuwait           | Qatar                | U.S. Virgin Islands      |
| Christmas Island       | Labuan           | Queshm Island        | Uruguay                  |
| Cocos (Keeling)        | Lebanon          | Samoa                | Vanuatu                  |
| Costa Rica             | Liberia          | San Marino           | Yemen                    |
| Djibouti               | Liechtenstein    | Seychelles           |                          |
| Dominica               | Maldives         | Solomon Islands      |                          |

<sup>5</sup> Order No. 150/2004, of February 13, as amended by Order No. 345-A/2016, of December 30, and by Order No. 309-A/2020, of December 31.

# UNITED KINGDOM

## Author

Eloise Walker  
Pinsent Masons LLP  
London, United Kingdom

## INTRODUCTION<sup>1</sup>

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

Currently, the U.K. has a unique taxation system for individuals who are resident but not domiciled in the U.K. known as the “remittance basis.” Individuals who are eligible to use the remittance basis are only liable to U.K. tax on foreign-source income and capital gains to the extent that those amounts are remitted to the U.K. This system has made the U.K. an attractive and cost-effective center for locating foreign executives.

Non-domiciled individuals (“Non-Doms”) seeking to benefit from the remittance basis must pay a tax charge if they have been resident in the U.K. for seven or more of the last nine tax years. The charge, known as the remittance basis charge (“R.B.C.”), increases as the period of U.K. residence increases. For tax years from to April 6, 2017, the following rates of R.B.C. apply:

- **£60,000:** Applicable to Non-Doms that have been resident in the U.K. for 12 of the last 14 tax years (the “12-year test”)
- **£30,000:** Applicable to Non-Doms that do not meet the 12-year test but have been resident in the U.K. for seven of the last nine years

When the R.B.C. was first introduced, it applied as a single £30,000 charge for individuals resident in the U.K. for seven of the last nine years. Since then, the R.B.C. has been amended and increased several times, in various attempts to restrict tax benefits for individuals that have been resident in the U.K. for an extended period. Consequently, different levels of the R.B.C. may apply for individual tax years between April 2008 and April 2017.

From April 2017 onwards, individuals who have been resident in the U.K. for at least 15 of the previous 20 tax years are deemed to be domiciled in the U.K. from the beginning of the sixteenth tax year. Consequently, these individuals are no longer eligible to claim the remittance basis and are taxed in the U.K. on their worldwide income and gains.

An important R.B.C. relief was introduced in April 2012, whereby foreign income and gains may be brought into the U.K. for the purpose of investing in certain U.K.

<sup>1</sup> This summary of U.K. law is correct as of July 23, 2024.

The author would like to acknowledge the contribution of Penny Simmons, a legal director of Pinsent Masons LLP, London, in its preparation.

companies without constituting a taxable remittance that is subject to U.K. tax. The relief applies to investments in private U.K. companies only. Broadly, the investment can be made by way of shares or debt and must be made within 45 days of the funds being brought into the U.K. The relief is not available where the funds are being remitted as part of a scheme or arrangement to avoid U.K. tax.

Foreign executives coming to work in the U.K. should also be aware of certain measures to combat the misuse of artificial dual contracts by non-domiciled employees. Broadly, the rules prevent U.K.-resident Non-Doms from electing to use the remittance basis for overseas employment income where these individuals are artificially separating U.K. and overseas employment duties by creating separate employment contracts with a U.K. employer and an associated overseas employer.

At the U.K.'s Budget on March 6, 2024, the government announced its intention to abolish the beneficial tax treatment available to Non-Doms. It is currently proposed that the remittance basis of taxation will be replaced with a simpler residence-based regime, which is expected to take effect from April 6, 2025. It is currently proposed that nonresident individuals coming to the U.K. who opt into the regime will not pay U.K. tax on foreign income and gains for the first four years of tax residence. The government has also announced an intention to move to a residence-based regime for inheritance tax and a consultation is expected to be published later in 2024.

However, at the time of writing, it is unclear how reforms to the regime will be implemented, since a Labour Government has come into power. Reforms are expected, nonetheless. The details of how the reforms will be implemented are unlikely to be confirmed before autumn 2024.

A statutory residence test ("S.R.T.") was introduced in April 2013 to determine whether an individual is tax resident in the U.K. and therefore, subject to U.K. income tax and capital gains tax ("C.G.T.") on their worldwide income and gains. Individuals should note that their tax residence status under the S.R.T. may differ from their tax residence in years prior to the introduction of the S.R.T.

## **Corporations**

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

- The U.K. has competitive corporate income tax rates. The main rate of U.K. corporate income tax increased to 25% from April 1, 2023. A reduced rate of corporate income tax at 19% is available for companies with profits of £50,000 or less. Companies with profits between £50,000 and £250,000 are taxed at a rate of 25% but are eligible to claim marginal relief.
- An exemption from corporate income tax is available for most dividends received from U.K.- and foreign-resident companies and is backed up by a foreign tax credit system where the exemption does not apply.
- No withholding tax is levied 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 ("R.E.I.T.'s").
- The U.K. offers an exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups. In general, there is no C.G.T.,

on the sale of shares in U.K. companies by nonresidents (except for certain companies with substantial interests in U.K. real estate, as discussed further below).

- There are no capital taxes on formation or paid-in capital of companies.
- The U.K. has an optional “Patent Box” regime to incentivize U.K. innovation and the development and retention of certain intellectual property rights. Broadly speaking, the regime allows qualifying companies to elect to apply a lower rate of U.K. corporate income tax on all profits attributable to qualifying patents, whether paid as royalties or embedded in the price of the products. The relief was phased in over five years, and as of April 1, 2017, it provides an effective corporate income tax rate of 10% on worldwide profits attributable to qualifying patents and similar I.P. rights.
- From July 1, 2016, a modified U.K. “Patent Box” regime was introduced that is based on the “modified nexus” approach. This approach looks more closely at the jurisdiction where the R&D undertaken in developing the patent or product actually takes place. It seeks to ensure that substantial economic activities are undertaken in the jurisdiction in which a preferential I.P. regime exists, by requiring tax benefits to be connected directly to the R&D expenditure. Further changes to the Patent Box regime were introduced in Finance (No. 2) Act 2017 to address fact patterns involving shared R&D undertaken by two or more companies. Currently, where R&D is undertaken collaboratively by two or more companies under a “cost sharing arrangement,” the companies involved are treated neutrally so that neither is disadvantaged or advantaged by the arrangement.
- Prior to April 2024, the U.K. had two R&D tax relief schemes. An above-the-line R&D Expenditure Credit (“R.D.E.C.”) was available for qualifying companies that incurred qualifying R&D expenditure. The R.D.E.C. was calculated directly as a percentage of the company’s R&D expenditure and subsidized the R&D. The credit was recorded in a company’s accounts as a reduction in the cost of R&D – that is, it was recorded above the tax line. From April 1, 2023, the R.D.E.C. increased to 20% from 13%. Although it was available to both large and small companies, it was more commonly claimed by larger companies. A separate R&D tax relief regime was available to small or medium-sized companies (“S.M.E.’s), provided certain conditions were met. The S.M.E. R&D relief allowed for a tax deduction for qualifying R&D expenditure. The rate of the effective deduction was reduced from 230% to 186% from April 1, 2023. Under the S.M.E. R&D relief, loss-making S.M.E.’s could also claim a cash repayment of the tax credit in return for surrendering R&D related losses – this was capped at 10% of the losses available for surrender.
- At the U.K.’s Budget in March 2021, the government announced that it would conduct a wide-ranging review into the U.K.’s R&D tax credit system with the stated objective of ensuring that the U.K. remains a competitive location for cutting edge research, that the reliefs continue to be fit for purpose, and that taxpayer money is effectively targeted. As part of this review, from April 2023, the definition of R&D costs that are eligible for tax relief was expanded to include cloud computing, data costs, and pure mathematics.

*“There are no capital taxes on formation or paid-in capital of companies.”*



- New territoriality restrictions were also introduced to ensure that U.K. R&D tax reliefs incentivize U.K. innovation and are appropriately targeted in a way that best benefits U.K. industry. Broadly, from April 1, 2024, tax relief is no longer available for R&D expenditure on non-U.K. R&D activities.

There is an exemption from the restriction for overseas R&D where it is necessary for R&D to be undertaken overseas due to geographical, environmental, or social conditions not present or replicable in the U.K., or where there are regulatory or other legal requirements for R&D to be undertaken outside the U.K.

- Separately, in January 2023, the U.K. Treasury published a consultation on introducing a new single R&D tax relief system based “as much as possible” on the existing R.D.E.C. Notwithstanding this consultation, from April 2023, the U.K. government introduced a new enhanced tax credit for loss-making research-intensive S.M.E.’s. Eligible companies were able to claim part of the tax credit as a cash repayment capped at 14.5% of losses.
- For accounting periods beginning on or after April 1, 2024, a new single R&D tax relief system has been introduced for companies seeking to claim U.K. tax relief for expenditure on qualifying R&D. The new scheme is based on the R.D.E.C. and will provide a 20% tax credit for qualifying R&D costs for eligible companies. The new scheme incorporates the restriction on claiming tax relief for overseas R&D.
- Under the new scheme, additional tax relief is available for certain research-intensive S.M.E.’s. Loss-making R&D intensive S.M.E.’s can claim an enhanced tax credit of 27% on qualifying R&D expenditure. A repayable cash credit rate of 14.5% may also be available to eligible loss-making companies. Broadly, an S.M.E. will be research intensive, where 30% of its total expenditure is on qualifying R&D.
- For companies with accounting periods beginning on or after December 31, 2023, the U.K. has introduced new rules imposing a global minimum corporate income tax rate of 15%. The new rules apply to large multinational groups with over €750 million in global revenues. The rules were introduced as part of the U.K.’s adoption of Pillar Two, or the Global Base Erosion Rules (“GloBE Rules”). Broadly, the new rules follow model rules published by the O.E.C.D. The Pillar Two Rules have been developed by the O.E.C.D. to address the tax challenges of digitalization of the global economy. Pillar Two Rules consist of two mechanisms for collecting tax: (i) the main rule – an income inclusion rule (“I.I.R.”); and (ii) the Undertaxed Profits Rule (“U.T.P.R.”), which is considered a backstop to the I.I.R. and ensures that the minimum tax charge will be collected in every jurisdiction in which the group operates.
- Under the U.K.’s I.I.R., there are two different top-up taxes:
  - **Multinational Top-up Tax.** Broadly, a U.K. parent of a multinational group with annual revenues of €750 million or more will be charged a top-up tax when a subsidiary is located in a non-U.K. jurisdiction and the group’s profits in that jurisdiction are taxed at a rate below the minimum effective rate of 15%.

- **Domestic Top-up Tax.** Broadly, this tax applies the rules of the Multi-national Top-up Tax to the U.K. operations of groups and certain entities to ensure that U.K. entities will be taxed at the minimum effective rate of 15% and therefore, will not be subject to additional top-up taxes under Pillar Two rules.
- The U.T.P.R. ensures that any top-up taxes that are not paid under another jurisdiction’s Pillar Two rules are brought into charge to U.K. tax. The U.T.P.R. is currently expected to be introduced in the U.K. for accounting periods beginning on or after December 31, 2024.
- The U.K. has the most extensive tax treaty network in the world, covering around 130 countries.

On January 31, 2020, the U.K. formally left the E.U. The U.K. then entered a transition period, which ended on December 31, 2020. During this period, all existing E.U. law, including previous decisions by the Court of Justice of the European Union (“E.C.J.”), continued to apply to the U.K., although the U.K. was no longer an E.U. Member State. The goal was to maintain legal certainty in connection with the exit. On December 24, 2020, the U.K. and E.U. agreed the E.U.-U.K. Trade Cooperation Agreement (“T.C.A.”), which defines the post-Brexit trading relationship between the E.U. and the U.K. from January 1, 2021. The U.K. enacted the E.U. (Future Relationship) Act 2020, which makes provision to implement the T.C.A in the U.K.

Until January 1, 2024, E.U. legislation continued to apply to U.K. tax legislation if it falls within the definition of retained E.U. law. However, following the introduction of the Retained E.U. Law (Revocation and Reform) Act 2023 (“R.E.U.L.”) Act 2023, the concept of E.U. supremacy over U.K. law was abolished. The R.E.U.L specified provisions in E.U. law that were revoked from December 31, 2023 – a few minor U.K. tax provisions were included.

Any direct retained E.U. law became what is known as “assimilated law” and would continue to apply in the U.K. subject to any relevant U.K. legislation. Going forward from January 1, 2024, the R.E.U.L. Act also removed the application of general principles of E.U. law in the U.K. This creates a two-tier system, where disputes/cases relating to matters occurring up to December 31, 2023, can still benefit from previously retained E.U. rights. In certain circumstances, the U.K.’s Supreme Court and the Court of Appeal can depart from assimilated case law.

U.K. V.A.T. and excise law was dealt with separately in Finance Act 2024, which took effect from February 22, 2024. The interpretation and application of U.K. V.A.T and excise law in the context of E.U. law is discussed further at **V.A.T.** below.

Beyond U.K. V.A.T. and excise law, in practice most previous judgments of the E.C.J. continue to apply when interpreting assimilated case law. However, assimilated case law is now subject to U.K. domestic legislation and must be viewed in the context that it could be set aside by the U.K.’s Supreme Court and the Court of Appeal.

## CORPORATE INCOME TAX RATE

As previously noted, the main rate of U.K. corporate income tax increased to 25% from April 2023.

## **U.K. Companies**

A company tax resident in the U.K. is liable to U.K. corporate income tax on its worldwide income and gains. Generally, capital gains realized by a U.K. company are included in profits for the purposes of calculating corporate income tax and are taxed at the same rate as income (currently 25%). However, there are exceptions to this rule, such as for gains realized on disposals of U.K. residential real estate assets (see below).

For U.K. corporate income tax purposes, trading profits are calculated by deducting certain reliefs and allowances together with expenses incurred wholly and exclusively for the purpose of the trade. Trading profits are taxed on an accruals basis and, generally, in accordance with the financial accounting treatment for determining profits and losses. The U.K. permits the use of U.K. generally accepted accounting principles (“G.A.A.P.”), or the International Accounting Standards. Generally, capital gains are taxed on realization.

## **Non-U.K. Companies**

Generally, a company that is not tax resident in the U.K. is liable to U.K. tax only on certain items of U.K.-source income and gains, such as rental income, and is generally taxed within the income tax regime. Most other U.K. income is taxable only to the extent that U.K. tax is withheld at the source, such as on certain interest payments.

However, a non-U.K. company may still be liable for U.K. corporate income tax if it trades in the U.K. through a U.K. permanent establishment, such as a branch or agent. In this case, the nonresident company would be liable for U.K. tax on worldwide income and gains related to that permanent establishment.

Under provisions introduced by Finance Act 2019 and effective April 2020, non-U.K. companies carrying on a U.K. real estate business or receiving income from U.K. real estate are liable for U.K. corporate tax on U.K.-related real estate income. This income includes profits arising from loan relationships or derivative contracts for which the company is a party for the purposes of its U.K. real estate business, electric-line wayleaves, and post-cessation receipts from U.K. property businesses.

U.K. corporate tax is applied as though the entity were a U.K. tax resident, and therefore, other U.K. tax rules apply to the non-U.K. company when computing the U.K. corporate tax payable. Such provisions include (i) restrictions on interest deductibility specific to the corporate tax regime, (ii) the use of corporate losses, and (iii) the corporate tax installment payment regime.

Effective April 2019, a nonresident company is liable to U.K. tax on gains realized on disposals of U.K. real estate. This is discussed in greater detail below.

## **Annual Tax on Enveloped Dwellings (“A.T.E.D.”)**

Certain non-U.K. companies (and other U.K. and non-U.K. “non-natural persons”) that hold certain high-value (*i.e.*, over £500,000) U.K. residential real estate assets are subject to an annual charge. The A.T.E.D. amount increases as the value of the real estate asset increases. The lowest rate is currently £4,400 (for real estate valued at more than £500,000 but less than £1,000,000), whilst the top rate is currently £287,500 (for real estate valued at more than £20 million).

Originally, the A.T.E.D. applied only to residential real estate assets valued at more than £2 million, but subsequent Finance Acts extended the scope of the tax so that the A.T.E.D. applies to residential real estate assets valued at more than £500,000. There are certain reliefs from the A.T.E.D. for genuine real estate development companies and rental companies.

### **Disposals of U.K. Real Estate (Subject to A.T.E.D.) from April 6, 2019**

With effect from April 6, 2019, the U.K. government introduced changes to the rules regarding the taxation of gains realized on the disposal of U.K. real estate by non-residents (prior to that time a complex set of priority rules applied to impose either A.T.E.D.-related C.G.T. or nonresident C.G.T. at special rates). The changes ensured that gains realized by nonresidents on disposals of U.K. real estate (both residential and nonresidential) are subject to U.K. C.G.T. or U.K. corporate tax on chargeable gains. The rules apply to direct and indirect disposals. For that reason, they can apply where a nonresident company disposes of an interest in an entity holding U.K. real estate.

The higher rate of C.G.T. (24% reduced from 28% since April 6, 2024) for disposals of interests in U.K. residential real estate by nonresidents continues to apply for disposals by individuals, trustees, and personal representatives.

The rules also apply to indirect disposals of U.K. real estate assets by nonresidents, although the “indirect charge” will only apply if the nonresident investor has at least a 25% interest in the entity owning the property (or had that level of interest at any time in the prior five years). Ownership of related parties will be aggregated for this purpose.

## **DIVIDENDS RECEIVED BY U.K. COMPANIES**

In principle, all dividends or other distributions received by U.K.-resident companies – no matter where the income arises – are subject to U.K. corporate income tax, unless specifically exempt.

Distributions received by companies, other than small companies (which are subject to their own regime), are exempt if that distribution (i) falls into an exemption, (ii) does not represent a payment of interest deemed to be a distribution, and (iii) does not qualify for a tax deduction with respect to a resident of any territory outside the U.K. under the laws of that territory.

The exemptions are widely drafted, and in practice, most distributions received by a company will fall under one of the following exemptions:

- **Distributions from Controlled Companies:** Broadly, this exemption applies when the recipient, alone or in conjunction with others, is in control of the company, in accordance with the relevant definition of control.
- **Distributions with Respect to Non-redeemable Ordinary Shares:** This exemption will cover most distributions with respect to ordinary shares by U.K. companies.
- **Distributions with Respect to Portfolio Holdings:** Broadly, these 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.:** These payments are usually taxed under different provisions.
- **Capital Distributions Made from Reserves Arising from a Reduction in Capital:** Distributions that are capital in nature and which fall outside of the “dividend exemption” may be subject to U.K. corporate income tax on chargeable gains, unless the Substantial Shareholding Exemption or another exemption or relief is available.

Several anti-avoidance provisions exist to prevent artificial avoidance or manipulation of these exemptions. Targeted schemes include, *inter alia*, deductions given for distributions, payments effected on non-arm’s length terms, and diversions of trade income. In addition, other anti-avoidance rules, including the general anti-abuse rule (“G.A.A.R.”) discussed below in **G.A.A.R. and Further H.M.R.C. Powers**, may prevent a taxpayer from claiming exemptions in certain cases.

The recipient of an exempt distribution can elect not to apply an exemption with respect to a particular distribution. The election must be made within two years of the end of the accounting period in which the distribution is received.

## FOREIGN TAX CREDIT FOR U.K. COMPANIES

Where the exemptions described above do not apply, double taxation issues may arise if a U.K. corporate recipient of a non-U.K. dividend would be subject to both U.K. tax and foreign tax in the jurisdiction from which the dividend is paid. To address this, tax relief may be available under the provisions of a double tax treaty between the U.K. and the relevant foreign jurisdiction.

Where an income tax treaty is not in place to provide relief, a credit is generally granted against U.K. tax for foreign withholding tax levied on non-U.K. dividends. A U.K. tax credit will not be available if the relevant income tax treaty expressly denies foreign tax credit relief under the particular circumstances of the U.K. corporate resident.

Generally, companies pay dividends out of taxed profits. If a nonresident pays foreign tax on profits out of which a dividend is paid, the foreign tax payment is referred to as an underlying tax. In the U.K., an indirect foreign tax credit may be allowed for underlying tax where the recipient is a U.K. tax resident company. Typically, this underlying tax credit will be available only where the U.K. recipient company has a substantial interest in the foreign payer.

Broadly, to meet the substantial interest standard, the recipient must directly or indirectly control, or be a subsidiary of a company that indirectly or directly controls, 10% or more of the voting power of the payer company. In limited circumstances, the underlying tax credit may be available even where the 10% control condition is not strictly met.

For the purpose of the underlying tax credit, underlying tax will generally include underlying tax from associated companies through an indefinite number of successive levels in the corporate chain. For this purpose, two companies are associated

if the shareholder receiving the dividend, directly or indirectly, controls 10% or more of the voting power in the paying company. A U.K. tax credit given for foreign tax will be reduced or denied if a foreign tax authority has repaid any amount of the foreign tax paid to (i) the recipient of the U.K. tax credit, (ii) any person connected with the recipient, or (iii) a third party as a result of a scheme (which is broadly defined). An example of the type of tax caught by this limitation is the tax paid by Maltese corporations and refunded to its shareholders.

### **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.

### **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 in conjunction with the introduction of the Substantial Shareholding Exemption. In the majority of cases, there will now be no U.K. tax liability levied on the corporate recipient of an overseas dividend and, therefore, there is no need for a credit pooling system to relieve any associated U.K. tax liability.

### **Anti-Avoidance**

A broad anti-avoidance rule, specifically aimed at foreign tax credits, exists to combat arrangements designed to secure excessive foreign tax credits, such as “dividend buying” schemes, where extra income is deliberately purchased to enhance the foreign tax credit of the purchaser. The rule 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 satisfies certain statutory conditions outlined below.
- 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.

Broadly, schemes or arrangements are those that meet any of the following criteria:

- The scheme or arrangement enables attribution of foreign tax, when the foreign tax is properly attributable to another source of income or gains.
- The scheme or arrangement concerns the effect of paying foreign tax, so that on entering the scheme it would be reasonable to expect that the total amount of foreign tax would be increased by less than the amount allowable as a tax credit.

*“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 scheme or arrangement involves deemed foreign tax, where an amount is treated as if it were foreign tax paid and either no real foreign tax would reasonably be expected to be paid or it would be reasonable to expect that the increase in foreign tax credit allowed exceeds the increase in actual tax paid.
- The scheme or arrangement concerns claims or elections for tax credits the effect of which is to increase or give rise to a claim for a relief by way of a tax credit.
- The scheme or arrangement reduces a person's reported tax liability.
- The scheme or arrangement involves tax-deductible payments.

H.M.R.C. will issue a counteraction notice where it has reasonable grounds to determine that one or more of the above scheme-related criteria have been met. Taxpayers will then have 90 days to determine whether to (i) accept H.M.R.C.'s application of the legislation and amend the self-assessment tax return as required or (ii) disregard the counteraction notice. Disputes regarding the application of the rules will be resolved through the normal self-assessment examination and appeals procedure. Where the counteraction notice is successfully invoked, the tax credit claim will be limited so as to cancel the effect of the scheme or arrangement.

Different rules apply where the underlying tax of a nonresident company is involved. In such circumstances, the counteraction will apply where, had the nonresident company that paid the foreign tax been a U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company.

### **Hybrid Instruments**

In certain limited circumstances, it may be possible for a foreign dividend, which is not exempt from U.K. corporate income tax, to give rise to a tax credit for the U.K. corporate recipient and also be deductible for the foreign payer for foreign tax purposes. Where this occurs, the U.K. corporate recipient will not obtain a U.K. tax credit for underlying foreign tax. The denial of credit for underlying 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**

There is no U.K. withholding tax on dividends paid by U.K. companies to U.S. shareholders as the U.K. does not impose withholding tax on dividends to nonresident shareholders as a matter of domestic law.

However, U.K. withholding tax at 20% applies to property income distributions ("P.I.D.'s") paid in relation to certain qualifying activities by R.E.I.T.'s to shareholders who are not within the scope of U.K. corporate tax (which can include companies not resident in the U.K.). This may be reduced by an applicable U.K. income tax treaty. Since a company will not be able to qualify as a R.E.I.T. if it has a corporate shareholder with a 10% or greater participation, treaty relief will be at the rate applicable to portfolio dividends. This rate currently is 15% for qualified U.S. residents under the U.K.-U.S. Income Tax Treaty. The position is essentially the same with respect to the 20% withholding that applies to P.I.D.'s made by property-authorized investment funds.

## DIVERTED PROFITS TAX

In January 2024, the U.K. government announced its intention to reform the Diverted Profits Tax (“D.P.T.”) and remove D.P.T.’s status as a separate tax by bringing it within the charge to U.K. corporate income tax. The government considers that this will clarify the relationship between the taxation of diverted profits and transfer pricing, and provide access to treaty benefits whilst maintaining key features of the regime. Draft legislation is currently expected to be published in 2024. However, it is unclear whether this timeline will be maintained by the new Labour Party Government.

D.P.T. is a U.K. tax aimed at multinationals operating in the U.K. that artificially siphon profits out of the U.K. or try to avoid a taxable establishment by playing the complexities of the tax system. It is primarily an anti-avoidance measure and was introduced in Finance Act 2015.

The rate of D.P.T. increased to 31% (from 25%) of the diverted profit from April 1, 2023, in line with the increase in the main rate of corporate income tax to 25%. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Companies likely to be affected by D.P.T. will often seek to restructure their operations, so as to derive profits in the U.K. and be subject to the lower U.K. corporate tax rate.

D.P.T. applies to diverted profits arising on or after April 1, 2015, although there were apportionment rules for accounting periods that straddled that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or permanent establishment and arrangements between connected parties “lack economic substance” in order to exploit tax mismatches. One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity in a tax haven that bears no relation to the provision of any property, service, or financing that was actually made to the U.K. subsidiary or permanent establishment.
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a permanent establishment in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. This is referred to as the “avoidance of a U.K. taxable presence.”

D.P.T. does not apply to S.M.E.’s.

Where companies or permanent establishments lack economic substance, there are two tests that must be considered: (i) the insufficient economic substance condition and (ii) the effective tax mismatch condition. If either test is met, a D.P.T. charge will be payable.

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction. Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the



contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person's involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that have a real financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party.

There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, or to certain off-shore funds or authorized investment funds.

Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporate income tax charge.

There will not be an avoidance of a U.K. taxable presence if the U.K. activity is undertaken by someone acting as an agent of independent status or for the purposes of alternative finance arrangements.

There are also specific exceptions from a D.P.T. charge if, in a 12-month accounting period, U.K.-related sales are below £10,000,000, or U.K.-related expenses are below £1,000,000.

Calculating the D.P.T. charge is complex and various rules must be considered. Broadly, it will be necessary to consider profits that would have arisen if the company made a full transfer pricing adjustment. It will also be necessary to determine the amount of profit that would have arisen from an alternative transaction that would have reasonably taken place if a tax reduction had not been relevant to the parties.

No taxable diverted profits should arise if, in the relevant transactions, the company made transfer pricing adjustments that put it in the same tax position as if arm's length pricing had been used.

D.P.T. has its own specific rules for assessment and payment. D.P.T. is not self-assessed; rather, companies have to notify H.M.R.C. if they are potentially within the scope of D.P.T. and do not satisfy any of the exemptions.

Following notification, if H.M.R.C. considers a company potentially liable for D.P.T., it will issue a preliminary notice to the company calculating the D.P.T. and outlining the grounds on which they consider D.P.T. to be payable. H.M.R.C. must issue a preliminary notice within two years of the end of the accounting period in which the D.P.T. charge arose. A company then has 30 days to contact H.M.R.C. to correct obvious errors in the notice, following which H.M.R.C. must either issue a charging notice stating the amount of D.P.T. payable, or notify the company that no D.P.T. is payable. The company then has 30 days from receipt of the charging notice to pay any D.P.T. due. There is no right to appeal the preliminary notice or charging notice.

prior to payment and there are no grounds for delaying payment.

Following payment, H.M.R.C. has 12 months to review the charge to D.P.T. During this time, the charge may be reduced or increased. The company can only appeal a D.P.T. charge after the 12-month review period has ended.

There is no formal clearance procedure for D.P.T., although it may be possible to obtain a written opinion from H.M.R.C. on the likelihood a D.P.T. notice will be issued.

## C.G.T. EXEMPTION ON THE DISPOSAL OF SUBSTANTIAL SHAREHOLDINGS

Any gains realized on a U.K. company's disposal of shares in an operating company may be exempt from U.K. tax if the gains qualify under the Substantial Shareholding Exemption (the "S.S.E."). The S.S.E. is available only if several conditions are satisfied by the company making the disposal (the "Seller") and the company that issued the shares being sold (the "Target Company"). The application of the S.S.E. is automatic and a company need not make an election in order to claim the benefit.

Where the S.S.E. would apply to a gain, but in fact a loss arises from the relevant transaction, that loss is disallowed for U.K. corporate tax purposes.

Broadly, the key conditions for the S.S.E. to apply relate to (i) the shares in the Target Company held by the Seller and (ii) the trading status of the Target Company and the Target's group.

### **The Seller's Shareholding in the Target Company (the "Shareholding Condition")**

To satisfy the Shareholding Condition, the Seller must meet the following requirements:

- The Seller holds 10% of the Target Company's ordinary share capital.
- The Seller is beneficially entitled to not less than 10% of the profits available for distribution to equity holders. Broadly, this includes all other ordinary shareholders in the Target Company and certain loan note holders.
- On a winding-up of the Target Company, the Seller would be beneficially entitled to not less than 10% of the assets available for distribution to equity holders.

The Seller must hold or have held the interests described above throughout a 12-month period beginning not more than six years before the date of the disposal of the relevant shares in the Target Company.

Qualifying institutional investors ("Q.I.I.'s") are not required to hold the 10% interest in the Target Company as described above. Where at least 25% of the ordinary share capital of the Seller is owned by Q.I.I.'s, the requirement relating to the Seller's shareholding is satisfied under the following conditions:

- The Seller holds ordinary shares, or interests in ordinary shares, in the Target Company, and the cost of the acquisition of such shares or interests was at least £20,000,000 (the "Value Test").



- The Seller’s beneficial interest in the Target Company is proportionate to the relevant shares or interests referred to for the purposes of the Value Test (or, where there is a difference in proportion, such proportion can reasonably be regarded as insignificant).

The “cost” of shares for the purposes of the Value Test means the value of the consideration given by the Seller (or on the Seller’s behalf) wholly and exclusively for the acquisition of the relevant shares or interests, together with any incidental costs of acquisition.

**Conditions Relating to the Trading Status of the Target Company (the “Trading Condition”)**

The Trading Condition requires that from the start of the latest 12-month period that is used for the purposes of determining whether the Shareholding Condition applies, the Target Company must be a “qualifying company.”

Prior to April 1, 2017, the Target Company also had to be a qualifying company immediately after the disposal of its shares. This position caused some practical difficulty in that the Seller was required to rely on a third-party buyer’s operation of the Target Company following the disposal. From, April 1, 2017, this condition is relevant only where both following facts exist:

- The relevant buyer and the Seller are connected.
- The relevant shareholding in the Target Company has been held by the Seller for less than 12 months, but the Shareholding Condition has been met by virtue of a transfer of trade to the Target Company from within the Seller’s group.

A Target Company is a qualifying company if it is a trading company or the holding company of a trading group. A trading company is a company carrying on trading activities and activities other than trading activities are not carried on “to a substantial extent.” A trading group has a similar definition, where one or more members carry on a trading activity and, when taken together, the activities of the group members do not include “to a substantial extent” activities other than trading activities. Broadly, for these purposes, H.M.R.C. considers the term “substantial” to mean more than 20%, although H.M.R.C. has cautioned that it will consider the facts and circumstances of each case when determining whether a company carries on non-trading activities to a substantial extent.

For the purpose of the S.S.E., a company will form part of a group if it is a 51% subsidiary of another company (*i.e.*, the parent). A company will be a 51% subsidiary of another company if the parent owns, directly or indirectly, more than 50% of the ordinary share capital of the subsidiary. When determining whether a group is undertaking trading activities, the group is treated as a single business.

The Target Company does not need be a U.K.-resident company for the S.S.E. to apply.

Gains derived from disposals of shareholdings that do not meet the requirements of the S.S.E. will be liable to U.K. corporate income tax. Consequently, capital losses should be allowable to offset against capital gains of the company.

## CAPITAL GAINS ON THE DISPOSAL OF SHARES BY A NONRESIDENT

Generally, no U.K. tax is payable on the disposal of shares in a U.K. company by a nonresident shareholder. A limited exception exists in the case of shares in oil companies whose value is based on exploration or exploitation rights in the U.K. sector of the North Sea. C.G.T. may also be payable on gains realized from the disposal of shares forming part of the assets of a U.K. branch of a nonresident company.

However, as outlined above, from April 6, 2019, U.K. tax is payable on gains realized by a nonresident on the sale of an interest including shares in an entity holding U.K. real estate.

## CAPITAL TAX AND STAMP DUTY

In the U.K., 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 may apply. For example, exemptions exist for certain intragroup transfers and transfers of shares on “recognized growth markets,” such as the Alternative Investment Market (“A.I.M.”).

Technically, stamp duty is a tax on documents. Therefore, U.K. stamp duty is payable on the sale of non-U.K. shares if the transfer document is signed in the U.K. Stamp duty must be paid by the purchaser within 30 days of signing. Failure to meet this deadline can result in penalties and interest.

Previously, a higher rate of stamp duty or S.D.R.T. of 1.5% could be charged where shares and securities were issued or transferred into a clearing system or a depository receipt facility. Prior to the U.K.’s departure from the E.U., this increased charge was successfully challenged under E.U. law, resulting in practice in the higher charge only applying to transfers of U.K. shares or securities into a clearing system or depository receipt facility in limited circumstances where the transfer is not an integral part of an issue of share capital or raising of capital. In January 2021, following the U.K.’s departure from the E.U., H.M.R.C confirmed that even though the U.K. left the E.U., the limitations on when the higher rate of S.D.R.T. could be charged would continue to apply.

However, following the introduction of the U.K.’s Retained E.U. Law (Revocation and Reform) Act 2023, which sought to revoke much of the E.U. law that continued to apply in the U.K., the 1.5% rate would have become chargeable on certain transfers of U.K. shares and securities into a clearing system or depository receipt facility. Consequently, Finance Act 2024 introduced measures to transpose the E.U. derived exemption into U.K. law. Broadly, from January 1, 2024, the 1.5% higher rate does not apply to any issue of shares and securities to a clearing system or depository receipt facility. The higher rate charge on transfers only applies in limited circumstances: essentially, when the transfers or instruments of transfer are not exempt capital-raising transfers or exempt listing transfers, and no other exemption from the higher rate charge applies.

*“In the U.K., 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.”*

Finance Act 2016 introduced a new provision to ensure that the transfer of U.K. securities into a depository receipt facility, or clearance system following the exercise of an option, will give rise to a 1.5% stamp duty or S.D.R.T. charge on the greater of the fair market value or option strike price, as of the date of the transfer.

This change was introduced to combat the avoidance of U.K. stamp duty and S.D.R.T. arising on the transfer of shares using Deep-in-the-Money Options (“D.I.T.M.O.’s”). An option is a D.I.T.M.O. when the strike price is significantly below fair market value.

Finance Act 2019 further updated the rules relating to the stamp duty and S.D.R.T. payable on documents transferring or agreements to transfer listed securities to connected companies. Effective October 29, 2018, the rate for such transfers will be the higher of the consideration for the transfer, or the market value of the listed securities.

With effect from July 22, 2020, the U.K.’s Finance Act 2020 extended this rule to the transfer of unlisted securities to connected companies, where some or all of the consideration for the transfer consists of the issue of shares. There must be some consideration for the rule to apply and therefore the rule does not apply to transactions such as gifts or distributions *in specie*.

On April 27, 2023, H.M.R.C. published a consultation on proposals to modernize the U.K.’s stamp tax on shares framework by replacing the current framework with a single tax on securities rather than having both stamp duty and S.D.R.T. It is currently proposed that the new tax would be self-assessed, bringing it in line with other modern U.K. taxes. The consultation period closed on June 22, 2023. There has been no announcement as to when (if at all) a new framework may be introduced.

## TAX TREATY NETWORK

As noted above, the U.K. has one of the most extensive tax treaty networks in the world – treaties are in effect with over 130 jurisdictions, listed below:

|                   |           |               |                   |
|-------------------|-----------|---------------|-------------------|
| Albania           | Fiji      | Liechtenstein | Serbia            |
| Algeria           | Finland   | Lithuania     | Sierra Leone      |
| Antigua & Barbuda | France    | Luxembourg    | Singapore         |
| Argentina         | Gambia    | Macedonia     | Slovakia          |
| Armenia           | Georgia   | Malawi        | Slovenia          |
| Australia         | Germany   | Malaysia      | Solomon Islands   |
| Austria           | Ghana     | Malta         | South Africa      |
| Azerbaijan        | Greece    | Mauritius     | South Korea       |
| Bahrain           | Grenada   | Mexico        | Spain             |
| Bangladesh        | Guernsey  | Moldova       | Sri Lanka         |
| Barbados          | Guyana    | Mongolia      | St. Kitts & Nevis |
| Belarus           | Hong Kong | Montenegro    | Sudan             |
| Belgium           | Hungary   | Montserrat    | Swaziland         |
| Belize            | Iceland   | Morocco       | Sweden            |
| Bolivia           | India     | Myanmar       | Switzerland       |

|                        |             |                  |                      |
|------------------------|-------------|------------------|----------------------|
| Bosnia & Herzegovina   | Indonesia   | Namibia          | Taiwan               |
| Botswana               | Ireland     | Netherlands      | Tajikistan           |
| Brunei                 | Isle of Man | New Zealand      | Thailand             |
| Bulgaria               | Israel      | Nigeria          | Trinidad & Tobago    |
| British Virgin Islands | Italy       | Norway           | Tunisia              |
| Canada                 | Ivory Coast | Oman             | Turkey               |
| Cayman Islands         | Jamaica     | Pakistan         | Turkmenistan         |
| Chile                  | Japan       | Panama           | Tuvalu               |
| China                  | Jersey      | Papua New Guinea | Uganda               |
| Croatia                | Jordan      | Philippines      | Ukraine              |
| Cyprus                 | Kazakhstan  | Poland           | United Arab Emirates |
| Czech Republic         | Kenya       | Portugal         | United States        |
| Denmark                | Kiribati    | Qatar            | Uruguay              |
| Egypt                  | Kosovo      | Romania          | Uzbekistan           |
| Estonia                | Kuwait      | Russia           | Venezuela            |
| Ethiopia               | Latvia      | San Marino       | Vietnam              |
| Falkland Islands       | Lesotho     | Saudi Arabia     | Zambia               |
| Faroe Islands          | Libya       | Senegal          | Zimbabwe             |

The U.K. signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Broadly, the U.K. treaty negotiating position aims to achieve the following goals:

- To reduce 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
- To prevent excessive foreign taxation and other forms of discrimination against U.K. business interests abroad
- To protect the U.K.'s taxing rights against attempts to evade or avoid U.K. tax

The latter point has become a driver for U.K. tax treaty policy, consistent with E.U. and O.E.C.D. policies.

The extensive U.K. treaty network is also significant in reducing or eliminating non-U.K. taxes on payments made to recipients that are U.K. tax resident. One specific aim of U.K. treaty policy is the elimination of withholding tax on interest and royalties. About one-quarter of the U.K. treaties achieve this goal. The remaining treaties typically reduce withholding tax rates. U.K. tax treaties commonly exempt disposals of shares from C.G.T. in the source state and almost all U.K. treaties reduce foreign withholding tax on dividends. Previously, pursuant to the European Interest and Royalties Directive (“I.R.D.”), intragroup interest and royalty payments could also be paid without withholding tax when paid to an associated company in another E.U. Member State. However, Finance Act 2021 repealed the transposition of the I.R.D. into U.K. law. Subject to the terms of the relevant tax treaty, withholding taxes apply to payments of annual interest and royalties made to E.U. companies from June 1, 2021.

Royalty payments made between connected parties are denied any benefit conferred by a U.K. double tax treaty if a main purpose of the arrangement is to secure a benefit that is contrary to the purpose of the relevant treaty. This can be viewed as an attack on holding companies that do not serve a business function separate from a reduction of withholding taxes.

## DEBT FINANCING OF U.K. COMPANIES

### The Deductibility of Interest Expense

The U.K. allows a company to deduct most forms of interest expense and other debt finance costs from its corporate income tax profits, therefore reducing a company's liability to U.K. corporate income tax. However, this is subject to a number of anti-avoidance rules and, since April 1, 2017, a wide-ranging general restriction on deductions claimed for corporate interest expense.

The tax deductibility of interest and other corporate finance costs was determined according to the U.K.'s "Loan Relationships" rules, which govern the taxation of corporate debt. Broadly, a loan relationship exists if there is a "money debt" arising from a transaction for the lending of money. This is the case where a company, within the scope of U.K. corporate income 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 Loan Relationships regime contains several anti-avoidance provisions to restrict excessive interest expense deductions in certain circumstances. One such provision is the "unallowable purpose rule," which operates to restrict a tax deduction where the relevant loan relationship has been entered into for an unallowable purpose. Broadly, a loan relationship will have an unallowable purpose if the transaction is entered into for non-commercial reasons, or reasons that do not have a business justification for the company. The exact scope and application of the unallowable purpose rule is complicated and there has been a significant amount of case law on its application.

A "targeted anti-avoidance rule" was also introduced for arrangements entered into from November 18, 2015. The rule is very widely drafted and could potentially apply to any financing transaction where the main or one of the main purposes is to obtain a tax advantage. The rule operates to counteract any tax advantage that may result from the transaction, including an interest expense deduction. The U.K. G.A.A.R. provisions may also operate to restrict an interest deduction in certain circumstances.

A restriction on the deductibility of interest expense may also be imposed by the U.K.'s thin capitalization rules, which are contained in the transfer pricing legislation. Under these rules, an interest expense deduction may be disallowed in certain circumstances. Currently, the thin capitalization rules do not have fixed ratios or safe harbors regarding the extent to which interest is deductible.

From April 1, 2017, general rules apply that restrict tax deductions for corporate interest payments by reference to a fixed ratio.

### Background to the New Rules – the B.E.P.S. Project

*“The Loan Relationships regime contains several anti-avoidance provisions to restrict excessive interest expense deductions in certain circumstances.”*

The U.K. government's decision to restrict the tax deductibility of corporate interest payments was driven by international pressure following the recommendations of the O.E.C.D.'s efforts to combat base erosion and profit shifting (the "B.E.P.S. Project").

The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis. Following international recognition that the global tax system needed reforming to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an Action Plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments (Action Item 4).

Action Item 4 focused on limiting B.E.P.S. via interest expense deductions, and specifically, on whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

### Overview of the U.K. Rules

Under the U.K. rules, tax relief for interest and certain other financing costs is limited to 30% of tax E.B.I.T.D.A., which is broadly defined as profits chargeable to corporate income tax, excluding interest, tax depreciation such as capital allowances, tax amortization, relief for losses brought forward or carried back, and group relief claimed or surrendered.

When applying the rules, groups generally need to work out the tax E.B.I.T.D.A. of each U.K.-resident member company and each U.K. permanent establishment and add them together. The limit on deductible interest is 30% of that figure.

There is a *de minimis* allowance of £2 million per annum, which means that groups with a net interest expense not exceeding this threshold are unaffected by the fixed ratio rule.

A company can carry forward indefinitely interest expense that has been restricted under the rules. The amount of interest expense that is carried forward may be treated as deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period, it can carry this forward and use it as additional interest capacity in subsequent periods, up to five years.

The restrictions apply to interest on existing loans as well as new loans, although limited grandfathering is available in certain circumstances. This is discussed in greater detail below.

### Group Ratio Rule

The rules include a group ratio rule ("G.R.R.") based on the ratio of net interest to E.B.I.T.D.A. for the worldwide group. The G.R.R. also allows deductions up to the ratio of net interest to E.B.I.T.D.A. for the worldwide group if it exceeds the fixed ratio. This is intended to help groups with high external gearing for genuine commercial purposes by substituting the G.R.R. for the fixed ratio rule if it gets a better result for the group.



The G.R.R. is calculated by dividing the net qualifying group interest expense by the group E.B.I.T.D.A. When calculating the G.R.R., while net interest is essentially calculated in the same way as for the fixed ratio rule, the worldwide “group E.B.I.T.D.A.” is an accounting measure; it broadly equals the consolidated profit before tax of the worldwide group, adjusted for depreciation and net interest.

The G.R.R. can be used as an alternative to the 30% fixed ratio rule. The total amount of the deductions available under the G.R.R. are capped at 100% of tax-E.B.I.T.D.A.

Interest on related-party loans, perpetual loans, and results-dependent loans is not included in the calculation of the G.R.R. A loan will not be treated as having been made by related parties where (i) no guarantee is provided by a member of the debtor’s group, (ii) financial assistance is only provided in relation to shares in the ultimate parent entity, (iii) the loans are made to a member of the group, or (iv) the financial assistance is a non-financial guarantee. Limited grandfathering is also available for guarantees provided prior to April 1, 2017.

### Public Infrastructure Exemption

To maintain investment in the U.K.’s infrastructure sector, there is an exclusion for interest paid on public infrastructure projects, known as the Public Infrastructure Exemption (“P.I.E.”). Infrastructure projects tend to be highly geared, and their viability is often dependent on the availability of debt financing. Without a specific exclusion, many infrastructure projects would not get off the ground due to lack of affordable debt financing and difficulty raising equity finance.

The P.I.E. is only available if an election is made and only applies to companies where all or significantly all of their income and assets relate to activities involving public infrastructure assets.

### Meaning of Public Infrastructure Assets

For this purpose, public infrastructure assets include (i) tangible U.K. infrastructure assets that meet a “public benefit test” and (ii) buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties.

The public infrastructure asset must also have or be likely to have an expected economic life of at least ten years, and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset meets the public benefit test if it is procured by a relevant public body, such as a government department, local authority, or health service body, or will be used in the course of an activity that is or could be regulated by an “infrastructure authority.” This second limb should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset.

The exemption also applies to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a “qualifying infrastructure asset” if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. Here, “short-term basis” means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

### Third-Party Debt Requirement

The P.I.E. only applies to interest paid to third parties where the recourse of the creditor is limited to the income, assets, shares, or debt issued by a qualifying infrastructure company, not necessarily the borrower.

Guarantees from parent companies or non-infrastructure companies within the group could prevent the exemption from applying. However, guarantees provided before April 1, 2017, and certain non-financial guarantees relating to providing the services are ignored.

### Grandfathering Provisions

Although the restrictions apply to interest on existing loans, limited grandfathering where existing arrangements are taken outside the scope of the new rules is available for infrastructure companies within the P.I.E. where (i) loan relationships were entered into on or before May 12, 2016 and (ii) at least 80% of the total value of the company’s future qualifying infrastructure receipts for a period of at least ten years was highly predictable by reference to certain public contracts.

The grandfathering exemption applies to interest on loans between related parties if the conditions are satisfied.

A transitional provision also applied in the first year to enable groups to restructure to fall within the P.I.E.

### Administration of the Interest Restriction Rules

The rules operate by assessing the level of interest in the worldwide group. Any restriction on the deductibility of interest cannot be processed through a company’s normal U.K. corporate tax return. U.K. companies also need to file an interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies. If a company elects to complete the short-form interest restriction return, it will not be able to use its interest allowance in a later period, although it will have 60 months to revoke its election and submit a full return.

Groups must appoint a reporting company to make the return. This is a company that is not dormant and is a U.K. group company, or a group member subject to U.K. corporate income tax for at least part of the relevant period to which the return relates.



## **Withholding Tax on Interest**

Generally, a U.K. company has a duty to withhold tax on U.K.-source payments of yearly interest. Currently, the rate of withholding is 20%. Broadly, “interest” will constitute “yearly interest” if it relates to debt that is intended to extend beyond one year.

There are a number of exemptions to this general rule. For example, there is currently no withholding tax on payments of interest to U.K. banks and U.K. corporate taxpayers.

Quoted Eurobonds also benefit from an exemption from U.K. withholding tax. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized exchange.

As explained above, bilateral tax treaties may also reduce the amount of withholding tax payable on interest payments to non-U.K. lenders. Administrative burdens arise when a reduction is claimed under a treaty.

Since January 1, 2016, there has been an exemption for certain qualifying private placements. A private placement is a type of unlisted debt instrument that is sold by way of a private offering to a small number of investors.

The exemption applies only to a security under the loan relationship rules. Therefore, it must be a money debt, as previously discussed. The term of the security must not be more than 50 years, and the aggregate value of the securities contained in the private placement must be at least £10 million.

The exemption is available only if the debtor holds a certificate from the creditor confirming that (i) the creditor is resident in an approved territory and is beneficially entitled to the interest in the private placement for genuine commercial reasons and (ii) the private placement is not being held as part of a tax avoidance scheme. Broadly, a country will be an approved territory if it has been designated as such by other U.K. tax regulations or it has a double tax agreement with the U.K. and the tax agreement has a non-discrimination article.

Debtors are also required to have entered into the private placement for genuine commercial reasons and not as part of a tax advantage scheme.

From April 6, 2017, certain open-ended investment companies (“O.E.I.C.’s”), authorized unit trusts (“A.U.T.’s”) and investment trust companies (“I.T.C.’s”) no longer have to withhold U.K. tax on interest distributions that are treated as payments of yearly interest.

## **ANTI-ARBITRAGE LEGISLATION**

From January 1, 2017, anti-avoidance rules, known as the “anti-hybrid rules,” were introduced in the U.K. These rules are based on the O.E.C.D.’s final recommendations in relation to Action Item 2 of the B.E.P.S. Project. Action Item 2 focused on the avoidance of tax using hybrid-mismatches. These arrangements exploit tax rules in different countries to enable a multinational to avoid paying tax in either country or to access excessive tax relief by deducting the same expense in more than one country. Broadly, the U.K.’s anti-hybrid rules operate to deny a U.K. tax deduction,

or to bring an amount within the charge to U.K. tax in intragroup transactions and third-party arrangements where certain “structured arrangements” exist, as defined by the rules.

## OFFSHORE INTANGIBLES

From April 6, 2019, a tax on U.K. sales linked to intangible property held in low tax jurisdictions (known as the “offshore receipts in intangible property” (“O.R.I.P.”) tax took effect. The O.R.I.P. tax introduced a 20% tax charge on offshore receipts from intangible property. The targets of the O.R.I.P. tax are multinational groups that hold I.P. such as patents in tax havens and exploit that I.P. to generate revenue from sales to U.K. customers.

The O.R.I.P. tax applies only to non-U.K. entities that are resident in jurisdictions which do not have a double tax treaty with the U.K. that contains a non-discrimination clause. On this basis, for the most part, the O.R.I.P. tax is expected to be restricted to tax havens and should not affect U.S. tax resident entities generating revenue in the U.K. from intangible property held in the U.S. or other suitable double tax treaty countries.

At the U.K.’s Autumn Statement in December 2023, the U.K. government announced that the O.R.I.P. tax would be abolished with effect from December 31, 2024. The repeal is scheduled to coincide with the introduction of the undertaxed profits rule in Pillar Two of the O.E.C.D. agreement to tackle profit shifting and aggressive tax planning by multinationals. The rationale for the repeal of the O.R.I.P. tax was that Pillar Two would more effectively discourage the multinational tax planning arrangements that the O.R.I.P. tax seeks to prevent.

## C.F.C.’S

### **Background**

The U.K. has anti-avoidance rules to combat tax avoidance using C.F.C.’s. A C.F.C. is a company that is resident outside the U.K. for tax purposes and controlled by one or more persons resident in the U.K. The objective of the U.K.’s C.F.C. regime is to prevent the artificial diversion of U.K.-taxable profits to subsidiaries or other corporate entities in low-tax jurisdictions.

In certain circumstances, the regime operates to attribute profits of the C.F.C. to a U.K.-resident company in the form of a C.F.C. charge. In 2010, the regime was substantially amended, largely as a result of successful challenges regarding the compatibility of the regime with E.U. law.

### **Overview of the Current Regime**

Broadly, the C.F.C. regime imposes a tax 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 C.F.C. regime. There are five categories of income that are regarded as U.K.-source and they are mutually exclusive:

*“Virtually every provision in the C.F.C. regime contains an anti-avoidance rule based on the presence of an intent to obtain the tax benefit as a principal reason for casting a transaction through a C.F.C.”*

- Profits of the C.F.C. that are derived from the exercise of significant functions by personnel based in the U.K. or attributable to U.K.-managed risks and assets
- Profits from the provision of finance where the capital is provided from the U.K. and the C.F.C. has profits derived, 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
- Profits of a subsidiary that has opted into the solo consolidation regime under the financial services regulatory rules

A company can be controlled from the U.K. by reason of, (i) shareholder control (“legal control”), (ii) ownership or entitlement to assets (“economic control”), or (iii) the treatment of the company as an undertaking by the U.K. parent for accounting purposes, even if consolidated accounts are not formally required (“accounting control”).

There are five exemptions that operate to reduce or exempt the profits falling within the C.F.C. charge. These are assessed at the entity level:

- The exempt period exemption, effectively a grace period
- The excluded territories exemption
- The low profits exemption
- The low margin exemption
- The tax 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 an anti-avoidance rule based on the presence of an intent to obtain the tax benefit as a principal reason for casting a transaction through a C.F.C. As indicated above, these will apply in addition to G.A.A.R.

Under the rules, a U.K. company will not be liable to a C.F.C. charge unless it holds a qualifying interest in the C.F.C., which, broadly, is ownership of at least 25% of share capital.

Prior to January 1, 2019, an important exemption applied to finance companies that satisfied certain conditions. The finance company exemption could be full or partial, set at 75%. Where the finance company partial exemption applied, the finance C.F.C. suffered an effective U.K. tax rate of 5% when the U.K. corporate income tax rate was 19% for the 2018-2019 tax year.

However, in October 2017, the European Commission

(“the Commission”) opened a formal investigation into whether provisions of the U.K.’s C.F.C regime, including this exemption, contravened E.U. law and specifically E.U. State Aid rules. In April 2019, the Commission ruled that the exemption amounted to unlawful State Aid and that the U.K. was required to recover the benefit

of the aid from any groups which had claimed the exemption.

In June 2019, the U.K. government formally applied to have the Commission's decision annulled. The U.K.'s appeal was published in August 2019. In June 2022, the C.J.E.U. dismissed the U.K.'s appeal. On August 31, 2022, it was reported that the U.K. had appealed against this decision.

On April 11, 2024, the Advocate General ("A.G.") of the C.J.E.U. issued an opinion that the E.U. Commission's decision should be annulled, since the finance company exemption under the U.K. C.F.C rules did not constitute unlawful state aid. However, the A.G.'s decision is not binding and the C.J.E.U. is currently reviewing the case with a further judgment expected in the future.

Notwithstanding the ongoing appeal process, the U.K. government remains under a duty to recover the alleged State Aid from the relevant companies who have benefited from the exemption. Consequently, it has proceeded with steps for an interim recovery.

In February 2020, H.M.R.C started writing to taxpayers that claimed the benefit of the exemption before January 1, 2019, requesting certain information to enable H.M.R.C to collect amounts that the Commission determined to be unlawful State Aid. In any event, the Finance Act 2019 removed the exemption for finance companies from the U.K.'s C.F.C. rules, with effect from January 1, 2019. The amendments were introduced to ensure that the rules would comply with the E.U.'s Anti-Tax Avoidance Directive ("A.T.A.D").

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

### **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 to the U.K. corporate shareholders. Capital gains are not within the C.F.C. rules. For this purpose, certain items that 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 I.P. assets will result in a potential apportionment of profit to U.K. corporate shareholders under the C.F.C. regime. The most common example is likely to be goodwill.

A separate regime applies to the attribution of capital gains of foreign companies to U.K. residents if the foreign companies would be considered to be "close companies" had they been U.K. resident, provided a targeted anti-avoidance test is met. Broadly, a company is a close company if it is under the control of five or fewer participants or participants who are also directors.

## **TAXATION OF FOREIGN BRANCHES OF U.K. COMPANIES**

Reflecting the rationale behind the creation of a wide tax exemption for U.K.-resident companies on receipt of dividends, as explained above in **Dividends Received by U.K. Companies**, the U.K.'s tax legislation contains a broad exemption from U.K.

corporate income tax for the overseas trading profits, gains, and investment income of a foreign branch of most U.K.-resident companies.

The term “branch” is a domestic equivalent of a permanent establishment and the calculation of profits falling within the exemption is determined in accordance with the income tax 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 if the exemption is not applied.

The regime applies to branches in all countries and territories – even those that do not have a treaty with the U.K. – but an irrevocable opting-in election must be made on an individual company basis.

Nonresident 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 G.A.A.R. provisions will also apply.

## V.A.T.

The U.K. charges V.A.T. on the supplies of most goods and services with notable exclusions, such as the supply of financial services. Currently, V.A.T. is charged at 20% (“standard rated”), although some supplies are charged at 0% (“zero rated”) and others at 5% (“reduced rated”). Ultimately, the burden of V.A.T. is intended to be borne by the final consumer. As a general principle of V.A.T. law, a fully “taxable person” should be able to recover all the input V.A.T. incurred in the course of its economic activities. The term “taxable person” is a concept used by the V.A.T. legislation to describe a person who is engaged in economic activities. Conversely, V.A.T. is not recoverable by the “end user,” which is 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.

The UK’s V.A.T. system is based on E.U. law. However, with effect from December 31, 2020, (the end of the transitional period following the U.K.’s departure from the E.U.) U.K. V.A.T. laws are not required to comply with the E.U.’s V.A.T. laws. Nonetheless, for the most part, the U.K. government has opted to continue the V.A.T. system broadly along current E.U. lines, subject to minor changes.

As discussed earlier in this chapter, following the introduction of the R.E.U.L. Act with effect from January 1, 2024, E.U. law is no longer supreme over U.K. law and no U.K. legislation can be quashed or disapplied on the basis of incompatibility with retained E.U. law. However, there was concern that the R.E.U.L. Act could lead to uncertainty in relation to U.K. V.A.T., giving rise to disputes regarding the interpretation of U.K. V.A.T. law that had been decided on E.U. principles.

Consequently, the Finance Act 2024, which took effect from February 22, 2024, included a provision confirming that although E.U. law is no longer supreme, retained general principles of E.U. law will continue to be relevant for the purpose of interpreting U.K. V.A.T. and excise law “in the same way, and to the same extent, as they were relevant for that purpose” before the R.E.U.L. Act.



In practice, this should mean that the status quo is retained regarding the relevance of E.U. principles when interpreting and applying U.K. V.A.T. and excise law. However, E.U. law cannot be used to disapply or quash U.K. V.A.T. legislation and the higher courts (the Court of Appeal and the Supreme Court) will have the power to diverge from retained E.U. case law when they consider it appropriate to do so.

A company with activity limited to the holding of shares in a subsidiary for the purpose of receiving a dividend does not carry on an economic activity for V.A.T. purposes. Therefore, any V.A.T. incurred on the costs of acquiring and holding shares by a parent company for the sole purpose of holding the shares generally is not recoverable. For V.A.T. to be potentially recoverable, the shares must be held for some other “economic” purpose. Consequently, U.K. 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, this will involve carrying on a business. If this can be achieved, the V.A.T. costs on share acquisitions or disposals and takeovers may be recoverable.

The V.A.T. treatment of supplies made by holding companies came under scrutiny by the E.C.J. in *A.B. v. SKF*<sup>2</sup> and by the U.K.’s Court of Appeal in *B.A.A. Limited v. The Commissioners for Her Majesty’s Revenue & Customs* (the “B.A.A. case”). In *A.B. v. SKF*, the sale of shares by SKF was found to be more than a mere passive disposal of securities. Instead, SKF demonstrated that it was actively involved in the management of its subsidiaries. This constituted an economic activity. In the *B.A.A.* case, the Court of Appeal held that V.A.T. incurred on advisors’ fees by the relevant group company, in connection with the takeover of the B.A.A. plc group in 2006, was not recoverable under the particular facts involved. Although the acquiring entity carried on an “economic activity” for V.A.T. purposes, the court found that the fees incurred by it related principally to the acquisition rather than the post-acquisition business of the acquired group.

Both these cases confirm that companies contemplating a share acquisition or disposal 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 acquiring entity showing an intention to supply taxable services to the target upon completion of the takeover. For example, it could supply management services in return for a fee. The intention to make taxable supplies may also be established where the acquirer is grouped for V.A.T. purposes with the target after completion of the takeover and clear evidence exists in the lead-up to the transaction that an intention to report on a group basis exists. In July 2015, in the joint cases of *Larentia* and *Minerva*,<sup>3</sup> the E.C.J. held that a holding company that actively manages its subsidiaries should be carrying out an economic activity for V.A.T. purposes. In principle, this decision recognizes that holding companies may recover V.A.T. on advisor’s fees and other costs relating to a corporate takeover, where those costs have a “direct and immediate link” with the holding company’s economic activities.

In 2016, the V.A.T treatment of supplies made by holding companies was considered by the Upper Tribunal in the case of *Norseman Gold Plc v. H.M.R.C.* and the First Tier Tribunal in *Heating Plumbing Supplies Ltd v. H.M.R.C.* On the facts, V.A.T

<sup>2</sup> *Skatteverket v. AB SKF*, Case C-29/08, [2009] E.C.R. I-10413.

<sup>3</sup> *Larentia & Minerva v. Finanzamt Nordenahm*, Joined Cases C-108-109/14, [2015] E.C.R. I \_\_\_\_ (delivered on July 16, 2015).



recovery was denied in *Norseman Gold*, but allowed in *Heating Plumbing Supplies Ltd*. In January 2016, H.M.R.C. announced that it intended to consult on reforming the U.K.'s V.A.T.-grouping rules. At the end of December 2016, H.M.R.C. published a consultation document that expressly considered whether to make any changes following recent E.C.J. decisions, but no changes were introduced.

However, in May 2017, H.M.R.C. published updated guidance, confirming that V.A.T. recovery can be made where the holding company is the recipient of the supply if certain conditions are satisfied. The conditions are as follows:

- The holding company making the claim must be the recipient of the supply. H.M.R.C. considers this condition satisfied where the holding company has contracted for the supply, including by novation, and it has made use of, been invoiced, and paid for the supply.
- The holding company must undertake economic activity for V.A.T. purposes. This condition will be satisfied where the holding company makes or intends to make supplies of management services for consideration to its subsidiaries. The management services must be genuine and provided for a consideration that is more than nominal. Full recovery may not be possible if management services are not supplied to all subsidiaries.
- The economic activity must involve the making of taxable supplies. The holding company should create and retain contemporaneous evidence of its intention to make taxable supplies. Full recovery may not be possible if in addition to providing management services, the holding company makes exempt supplies in providing loans to the subsidiaries. However, H.M.R.C. guidance confirms that where the holding company is lending money to companies within a V.A.T. group and these loans can be seen to support the making of taxable supplies by the V.A.T. group, the related V.A.T. will be recoverable to the extent that the costs support taxable supplies made. This is the case whether the transactions within the group would be taxable or exempt supplies were they not disregarded because of the V.A.T. grouping.

In subsequent case law, H.M.R.C. (and the higher courts) have made it clear that they do not look favorably on V.A.T. recovery in connection with deal fees relating to the purchase and sale of subsidiaries by holding companies, and while recovery may be possible in certain circumstances, this remains an uncertain area.

In August 2020, H.M.R.C. published a new call for evidence on potential changes to the U.K.'s V.A.T. grouping rules. In March 2021, the government announced that it would not proceed with changing the rules.

## **G.A.A.R. AND FURTHER H.M.R.C. POWERS**

### **G.A.A.R.**

The G.A.A.R. was introduced in the U.K. in July 2013, with the broad intention of counteracting “tax advantages” arising from abusive tax arrangements. This includes obtaining or increasing relief from tax. For the purposes of the G.A.A.R. provisions, a tax arrangement includes agreements, understandings, and transactions to obtain tax relief, whether or not legally enforceable. The G.A.A.R. applies to most U.K. taxes, other than V.A.T.

All of the following conditions must be satisfied for the G.A.A.R. to apply:

- An arrangement giving rise to a tax advantage is present.
- The tax advantage relates to a tax covered by the G.A.A.R.
- One of the main purposes of the arrangement is to obtain the tax advantage (taking into account all facts and circumstances).
- The arrangement is “abusive.”

Arrangements will be considered to be abusive if they cannot reasonably be 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 may be considered when ascertaining whether a transaction is abusive include the following:

- 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
- Whether the arrangement exploits any shortcomings in the legislation

The legislation sets out indications that a transaction is likely to be abusive and includes cases where the tax position does not reflect the economic reality, such as when an interest expense deduction is greater, for tax purposes, than the amount actually paid. Arrangements that are in accordance with established and acknowledged H.M.R.C. practice will generally not violate G.A.A.R. principles.

Before the G.A.A.R. is applied by H.M.R.C., an opinion of the “independent” Advisory Panel must be obtained. The Advisory Panel is technically part of H.M.R.C. It consists of senior industry and business experts and opines only on the issue of whether a course of action undertaken by the taxpayer is reasonable under 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.

Where the G.A.A.R. applies, H.M.R.C. will be entitled to counteract the tax advantage. To illustrate, it may deny a deduction for interest expense.

There is no clearance procedure enabling taxpayers to obtain confirmation from H.M.R.C. that the G.A.A.R. will not apply to a particular transaction. However, depending on the transaction type and circumstances, other clearances in comparable circumstances will be available over time.

H.M.R.C. has published Advisory Panel guidance on its interpretation of the G.A.A.R., including examples of where the G.A.A.R. will apply. The guidance confirms arrangements reflecting straightforward choices, such as funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, and as mentioned above, arrangements that are in accordance with long-established practice will not be subject to the G.A.A.R. unless contrived.

***“Arrangements will be considered to be abusive if they cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances.”***

## **Disclosure of Tax Avoidance Schemes**

The Disclosure of Tax Avoidance Schemes (“D.O.T.A.S.”) rules were introduced in Finance Act 2004 and broadly require the promoters of certain tax avoidance schemes to disclose details to H.M.R.C. Essentially, the D.O.T.A.S. regime is intended to facilitate H.M.R.C.’s identification of potential tax avoidance schemes at an early stage, with a view to taking action to close down abusive schemes where appropriate.

Following a disclosure under D.O.T.A.S., H.M.R.C. may issue a scheme reference number (“S.R.N.”). Subsequently, taxpayers who choose to use the scheme are required to put the S.R.N. on self-assessment tax returns.

Broadly, the rules apply where (i) there are “arrangements” that are expected to provide a tax advantage, (ii) receiving a tax advantage is expected to be one of the main benefits, and (iii) the scheme falls within one of several descriptions (known as “hallmarks”). Currently, the hallmarks are aimed at new and innovative schemes, marketed schemes, and specific targeted schemes.

### **D.A.C. 6 (Replaced by M.M.D.R. in the U.K.)**

On June 25, 2018, E.U. Directive (2018/822/E.U.) (known as D.A.C.6.) entered into force. D.A.C.6. is designed to give E.U. tax authorities early warning of new cross-border tax schemes that might be used to avoid tax. It requires tax authorities to be notified of cross-border tax arrangements satisfying certain “hallmarks.” The tax authorities will then automatically exchange the information with other relevant E.U. tax authorities.

The rules have been in force in E.U. member states since July 1, 2020, but the first reporting obligations were deferred by most E.U. countries until 2021 because of the COVID-19 pandemic.

The U.K. enacted D.A.C.6 and the U.K. government stated it was committed to applying them even after the U.K. left the E.U. However, on December 30, 2020 the government confirmed that the U.K. rules would be amended so that reporting requirements would only be required in the U.K. in respect of Hallmark D of D.A.C.6.

Hallmark D is based on the Model Mandatory Disclosure Rule (“M.M.D.R.”) proposed by the O.E.C.D. It covers arrangements designed to circumvent the common reporting standard (“C.R.S.”) and arrangements intended to disguise beneficial ownership.

In March 2021, the U.K. government announced that it would replace D.A.C.6 with new rules implementing the M.M.D.R. On March 28, 2023, D.A.C.6 was revoked and replaced with new disclosure rules based on the M.M.D.R. Broadly, the new rules require a disclosure to be made where there is an aggressive cross-border tax arrangement that seeks to circumvent the C.R.S. or avoid tax using opaque offshore structures. The new rules have broader application than D.A.C.6 since they are not limited to arrangements involving an E.U. Member State. The new rules apply to pre-existing arrangements from June 25, 2018 onwards and must be reported by September 25, 2023.

## **Accelerated Payment Notices**

Finance Act 2014 introduced new powers for H.M.R.C. to combat tax avoidance by way of Accelerated Payment Notices (“A.P.N.’s”). Since July 2014, H.M.R.C. has been able to demand the payment of disputed tax associated with a tax avoidance scheme upfront, before a tribunal or court has decided whether a scheme is effective. The demand is made in the form of an A.P.N., which can be issued where schemes demonstrate certain “avoidance hallmarks,” such as being subject to disclosure under the D.O.T.A.S rules, or the issuance of a counteraction notice under the G.A.A.R. A.P.N.’s can be issued in relation to schemes that were entered into before the A.P.N. legislation came into force.

In brief, once an A.P.N. is issued, a taxpayer has 90 days to pay the tax, unless they successfully make representations to H.M.R.C. that the notice should not have been issued. However, representations can be made only on the grounds that the statutory conditions for the notice to be issued were not fulfilled. Examples are (i) the scheme was not a D.O.T.A.S. scheme, and for that reason, should not have been notified under the D.O.T.A.S. regime and (ii) the amount claimed in the A.P.N. is incorrect. There is no right of appeal against an A.P.N. Advance payments will be repaid to the taxpayer with interest in the event that the scheme is ultimately proven to be legitimate.

The introduction of the A.P.N. regime has proved controversial, and the validity of a number of A.P.N.’s has been challenged by judicial review. To date, no judicial review challenge has been successful, and A.P.N.’s remains a powerful tool in H.M.R.C.’s crusade against tax avoidance.

## **Follower Notices**

Alongside A.P.N.’s, Finance Act 2014 introduced the power for H.M.R.C. to issue Follower Notices (“F.N.’s”), which are aimed at marketed tax avoidance schemes where H.M.R.C. has already succeeded in the courts against one scheme user.

H.M.R.C. can issue an F.N. to a taxpayer when a final judicial ruling has been reached in relation to a tax avoidance scheme and H.M.R.C. considers that the principles in the ruling can be applied to deny the tax advantage being claimed by another taxpayer. A final judicial ruling is one that cannot be further appealed.

An F.N. may require the taxpayer to amend its return, if the return is still under examination, or enter into an agreement with H.M.R.C. to settle the dispute, where the taxpayer is appealing a tax assessment. The taxpayer is also required to give H.M.R.C. notice that it has taken the necessary corrective action and notifying H.M.R.C. of the amount of additional tax that has become payable as a result. The taxpayer has 90 days in which to comply.

## **Notification of Uncertain Tax Treatments**

### **Background to the Rules**

With effect from April 1, 2022, large businesses are required to notify H.M.R.C. where they have adopted an “uncertain tax treatment.” Legislation included in the U.K.’s Finance Act 2022 introduced new rules to ensure that H.M.R.C. becomes aware at an earlier stage if a large business has adopted a tax treatment that is contrary to H.M.R.C.’s known position.



The intention to introduce new rules of this nature was first announced in the U.K.'s Budget in March 2020 (with implementation expected in April 2021). The original proposals envisaged a very broad set of notification requirements (for example, to cover a fact pattern where business *believed* that H.M.R.C. may not agree with its interpretation of tax legislation). However, following extensive consultation and a delay to implementation, the scope of the rules has been significantly narrowed. H.M.R.C. has confirmed that the U.K. government remains committed to considering whether to extend the scope of the rules further to include a requirement to notify where there is a substantial possibility that a tribunal or court would find the taxpayer's position to be incorrect in material respects.

### *The Meaning of "Uncertain Tax Treatment"*

Broadly, an "uncertain tax treatment" will be defined by reference to two criteria:

- Whether a provision has been made in the business's accounts for the uncertainty (to reflect the possibility that a different tax treatment will be applied to a transaction); and/or
- Whether the tax position taken by the business (either wholly or in part) is contrary to H.M.R.C.'s known interpretation or application of the relevant law, as stated in the public domain or in previous dealings with H.M.R.C.

There is a minimum threshold for the new rules to apply. Broadly, a tax treatment will be "uncertain" only if it, and any related uncertain amounts, result in a difference of more than £5 million between the business's calculation of its tax liability and H.M.R.C.'s calculation of its tax liability.

Broadly, two uncertain tax amounts are "related" if

- both amounts are included in the same return, or a return for the same tax in the same financial or accounting period,
- both amounts relate to the same tax, and
- the tax treatment applied in arriving at one amount is substantially the same as the tax treatment applied in arriving at the other amount.

### *The Requirement to Notify*

The notification requirements only apply to "uncertain amounts" in respect to a liability for corporate income tax, income tax (including employment income tax), or V.A.T.

Broadly, a business is not required to notify H.M.R.C. about an amount if it is reasonable for the business to conclude that H.M.R.C. already has available all, or substantially all, of the information relating to that amount that they would be required in the notification to H.M.R.C.

A notification is not required where a separate notification has already been made under D.O.T.A.S. or the M.M.D.R., as discussed above.

H.M.R.C.'s position on a matter is taken to be "known" if it is apparent from published guidance, statements, or other H.M.R.C. material that is of general application and in the public domain, or through dealings with H.M.R.C. by or in respect of

*“The offenses effectively make a business vicariously liable for the criminal acts of its employees and other persons “associated” with it, even if the senior management of the business was not involved or aware of what was going on.”*

the business, whether or not they concern the amount in question, or the transaction to which the amount relates.

The new rules only apply to large businesses (including companies, partnerships, and limited liability partnerships). A large business is one with a U.K. turnover above £200 million and/or a U.K. balance sheet total over £2 billion. If one of these thresholds is met, the new rules will apply irrespective of whether the business is incorporated or formed in the U.K. Collective investment schemes are excluded from the new regime.

### Penalties for Noncompliance

An initial failure to report an uncertain tax treatment will give rise to a penalty of £5,000. A second failure to report within three years of the first failure will give rise to a further penalty of £25,000. Any subsequent failure in the same three-year period in relation to the same tax will give rise to an additional penalty of £50,000. A business will be able to appeal a penalty and attempt to rely on a defense of there being a “reasonable excuse” for failure to notify.

## **CORPORATE CRIMINAL OFFENSES OF FAILING TO PREVENT THE FACILITATION OF TAX EVASION**

### Background to the Offenses

On September 30, 2017, the Criminal Finances Act 2017 introduced two corporate criminal offenses (“C.C.O.’s”) of failing to prevent the facilitation of tax evasion, whereby a business will be held criminally liable if it fails to prevent its employees or any person associated with it from facilitating tax evasion.

### The Offenses

The legislation creates two offenses. The first offense applies to all businesses, wherever located, in respect to the facilitation of U.K. tax evasion. The second offense applies to businesses with a U.K. connection in respect to the facilitation of non-U.K. tax evasion.

The C.C.O.’s apply to both companies and partnerships. The offenses effectively make a business vicariously liable for the criminal acts of its employees and other persons “associated” with it, even if the senior management of the business was not involved or aware of what was going on.

There are two requirements for the C.C.O.’s to apply:

- Criminal tax evasion – and not tax avoidance – must have taken place.
- A person or entity who is associated with the business must have criminally facilitated the tax evasion while performing services for that business.

Associated persons are employees, agents, and other persons who perform services for or on behalf of the business, such as contractors, suppliers, agents, and intermediaries.

For either of the offenses to apply, the employee or other associated person must have criminally facilitated the tax evasion in its capacity as an employee or associated person providing services to the business. A company cannot be criminally liable for failing to prevent the facilitation of tax evasion if the facilitator was acting in a personal capacity.

### **Reasonable Prevention Procedures**

A company will have a defense against criminal liability if it can prove that it had put in place reasonable procedures to prevent the facilitation of tax evasion from taking place, or that it was not reasonable under the circumstances to expect there to be procedures in place. H.M.R.C. has published guidance on the offenses in which it explains that there are six guiding principles that underpin the defense of having reasonable prevention procedures:

- Risk assessment
- Proportionality of risk-based prevention procedures
- Top level commitment
- Due diligence
- Communication, including training
- Monitoring and review

A company must undertake a risk assessment to identify the risks of facilitation of tax evasion within the organization and the potential gaps in the existing control environment. The risk assessment should be documented so that it can provide an audit trail to support policy decisions regarding the implementation of new procedures to reduce the risk of exposure to the C.C.O.'s.

It is expected that following a risk assessment, most companies will introduce changes to ensure that they have robust procedures in place to prevent their employees, service providers, agents, suppliers, and customers from engaging in or facilitating tax evasion.

Securing top level commitment from a company's board and/or senior executives will be important in mitigating the risks of exposure to the C.C.O.'s and implementation of a policy in responses to the offenses is vital. Companies will need to adopt training programs on anti-facilitation of tax evasion and the C.C.O.'s and the programs should be available to all staff to accord with best practices.

### **Territoriality**

There are two separate offenses that apply where U.K. or non-U.K. tax is evaded. In relation to U.K. tax, the offense will apply to any company or partnership, wherever it is formed or operates. Where non-U.K. tax is evaded, a business will have committed an offense if the facilitation involves (i) a U.K. company or partnership, (ii) any company or partnership with a place of business in the U.K., including a branch, or (iii) if any part of the facilitation takes place in the U.K. In addition, the foreign tax evasion and facilitation must amount to an offense in the local jurisdiction and involve conduct that a U.K. court would consider to be dishonest.

## **Distinguishing Between Tax Avoidance and Tax Evasion**

As noted above, the C.C.O.'s will only apply when there has been fraudulent tax evasion. Fraudulent tax evasion is a crime and involves dishonest behavior. A person behaves dishonestly if he or she is aware of, or turns a "blind eye" to, his or her liability to pay tax but decides not to pay or declare the tax. Dishonest behavior may involve a person simply deciding not to declare income. It may involve someone deliberately trying to hide or misrepresent the source of money. In most countries, such dishonest tax evasion is considered illegal and therefore a crime.

Fraudulent tax evasion does not arise where a person makes a mistake or is careless. It also does not arise where a person actively seeks to avoid tax. A person's attempts to avoid tax may involve using complicated and artificial structures to exploit gaps in the rules of the tax system. Tax avoidance will usually involve arrangements to move assets from one place to another to secure a better tax treatment. Tax authorities may not agree that what has been done is legally effective and may challenge the taxpayer.

Even if the tax authority successfully challenges a tax avoidance arrangement and the taxpayer is required to pay additional tax, the taxpayer will not have acted dishonestly if a reasonable belief is held that the tax was not due when the arrangement was entered, even though a taxpayer understands that the belief may be proven wrong. Tax avoidance becomes evasion only where the taxpayer dishonestly withheld or misrepresented information to try to make the planning appear effective when it is not in fact effective.

In relation to the C.C.O.'s, the facilitator must also have a criminal intent and thus be an accomplice. At its simplest, this will occur where the facilitator knows that he is helping another person to carry out fraud. Unwitting facilitation of tax evasion is not enough, nor would knowing facilitation of tax avoidance be enough.

## **F.A.T.C.A. – U.K. IMPLICATIONS**

### **Background to Domestic Implementation**

The U.S. government introduced the Foreign Account Tax Compliance Act as part of the Hiring Incentives to Restore Employment Act of 2010. F.A.T.C.A.'s primary function is to require financial institutions ("F.I.'s") outside the U.S. to report information on U.S. account holders to the I.R.S. The associated penalty for noncompliance is the "big stick" of a 30% U.S. withholding tax on certain income and principal payments to recalcitrant F.I.'s by all persons, even those unrelated to the U.S. account in issue.

In the U.K., concerns were raised by the financial sector about the legal difficulties in complying with F.A.T.C.A. reporting. Particularly, F.I.'s foresaw issues with respect to U.K. data protection laws and a subsequent negative impact on the competitiveness of U.K. financial institutions ("U.K.F.I.'s") as a result of withholding on U.S.-source payments.

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. These discussions resulted in the publication of a joint statement on February 8, 2012, which set out an agreement to explore an intergovernmental approach, and the Model Intergovernmental Agreement to Improve Tax Compliance to Implement F.A.T.C.A. on July 26, 2012. This model has become the norm for U.S. agreements with other jurisdictions worldwide.

The U.K. entered into a bilateral intergovernmental agreement (“I.G.A.”) based on this Model Agreement that was signed on September 12, 2012.

### **Implementation of the I.G.A.**

Section 222 of Finance Act 2013 empowers the U.K. Treasury to make regulations giving effect to the U.K.-U.S. I.G.A. Accordingly, the International Tax Compliance (United States of America) Regulations 2013,<sup>4</sup> 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 F.A.T.C.A. regulations published by the I.R.S. is treated as having the same definition as in the I.G.A.

### **Implications of the I.G.A.**

The U.K.-U.S. I.G.A. has resulted in the following:

- F.A.T.C.A. withholding is 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 report the relevant F.A.T.C.A. information to H.M.R.C., instead of the I.R.S., which is designed as a mechanism to avoid U.K. and E.U. data protection issues.
- U.K.F.I.’s F.A.T.C.A. reporting requirements are aligned with existing domestic anti-money laundering processes as a way to reduce compliance costs and burdens.
- There is a wider category of effectively exempt institutions and products.
- There is an element of reciprocity so that the U.K. receives information from the U.S.

For F.I.’s in the U.K., compliance with the U.S. Internal Revenue Code is intended to be superseded by equivalent obligations under the U.K. I.G.A. and its implementing legislation. The U.K. is responsible for enforcement of these obligations, in the first instance. Failure to comply with the U.K. rules will result in having to comply with the primary F.A.T.C.A. legislation in order to avoid withholding.

F.A.T.C.A. is particularly complex and its exact application can be uncertain. Most F.I.’s demand information regarding the U.S. or non-U.S. status of all customers or customers having accounts in excess of a certain amount. Where a U.K. holding company may be obliged to comply with F.A.T.C.A. as implemented in the U.K., information on the U.S. status of substantial holders must be provided to the U.K.F.I.

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<sup>4</sup> SI 2013/1962.

# THE COMMON REPORTING STANDARD

## **Background**

The Common Reporting Standard (“C.R.S.”) was developed by the O.E.C.D. and provides a mechanism for countries to automatically exchange tax information. Specifically, the C.R.S. allows countries to obtain information from resident F.I.’s and automatically exchange that information with other countries.

The C.R.S. has been incorporated into U.K. law by the International Tax Compliance Regulations 2015. Reporting under the C.R.S. was introduced in 2016, with different countries adopting the regime at different times.

The U.K. was one of 56 jurisdictions that were “early adopters” of the C.R.S. and undertook to adopt reporting requirements from January 1, 2016. U.K.F.I.’s were required to commence reporting of specified information to H.M.R.C. by May 31, 2017. H.M.R.C. then committed to exchange the relevant information with participating jurisdictions by September 30, 2017.

The aim of the C.R.S. is to crack down on the use of offshore jurisdictions to facilitate tax evasion. A notable exclusion to the list of participating countries is the U.S. However, the reason for the U.S. exclusion is that F.A.T.C.A. already exists as a mechanism for identifying assets held offshore by U.S. citizens and U.S.-resident individuals.

Under the C.R.S., an entity that is an F.I. must carry out due diligence on its “account holders” – generally, persons who have debt or equity interests in that F.I. A wide variety of entities can constitute F.I.’s that are subject to reporting obligations, including banks, companies, and trusts. Entities that are not F.I.’s may be required to undertake certain due diligence procedures in support of self-certification obligations to F.I.’s.

F.I.’s report the collected information to the tax authority in their home jurisdiction. If any of those reported account holders are tax resident in another jurisdiction that has signed up to the C.R.S., the information covering the account holder will be forwarded to the relevant jurisdiction not later than nine months after the end of the calendar year on which the report is made.

The C.R.S. was modeled on and closely follows F.A.T.C.A., although the two regimes differ in certain respects. Given that the U.S. has not committed to exchange information under the C.R.S., F.A.T.C.A. arrangements under the U.K.-U.S. I.G.A remains in place. Ultimately, F.A.T.C.A. and the C.R.S. run parallel to each other, with F.A.T.C.A. remaining in place for U.S. citizens (including green card holders) and U.S. tax residents, and the C.R.S. applying for many other jurisdictions.

## **Enforcement of the C.R.S.**

The C.R.S. is enforced by way of a penalty system. Different jurisdictions may operate different penalty systems for noncompliance.

In the U.K., there are a series of penalties that may apply to noncompliant F.I.’s. There is an automatic penalty of £300 for failing to comply with the C.R.S. and an additional £60 per day penalty if the failure to comply continues after a warning is

*“The aim of the C.R.S. is to crack down on the use of offshore jurisdictions to facilitate tax evasion.”*

received from H.M.R.C. There is also an additional flat-rate penalty of £3,000 if H.M.R.C. determines that there are errors on the C.R.S. return itself.

In addition to these specific C.R.S.-related penalties, H.M.R.C. may also levy tax-related penalties under the existing tax penalty regimes. There is a specific penalty regime for offshore tax evasion, which was recently strengthened.

U.K. taxpayers who may be liable to tax-related penalties under the C.R.S. should be aware that the percentage penalty can be increased, depending on the territory and the severity of the offence, to up to twice the original tax cost if there is an offshore element involved.

## BELGIUM

### Author

Werner Heyvaert  
AKD Benelux Law Firm  
Brussels, Belgium

Over the last decades, Belgium has become a competitive player in the international tax arena. Despite a relatively high corporate income tax (“C.I.T.”) rate of 25% in comparison with some other E.U. jurisdictions, Belgium offers a wide-range of tax-planning opportunities for Belgian holding and operating companies and Belgian branches of foreign companies.<sup>1</sup>

These opportunities include, but are not limited to, the following:

- The participation exemption, also referred to as the dividend received deduction (“D.R.D.”),<sup>2</sup> which fully exempts from C.I.T. dividends received from qualifying subsidiaries and capital gains realized on the shares of qualifying subsidiaries
- The innovation income deduction, which allows a deduction of 85% of qualifying innovation income determined in accordance with the O.E.C.D.’s nexus rules<sup>3</sup>
- The increased investment deduction, which allows the deduction of a percentage of the acquisition or investment value of qualifying assets that have been acquired or developed during the taxable period and are related to R&D. This deduction comes in addition to the annual depreciation of qualifying assets.
- Tax losses may be carried forward indefinitely
- The ruling practice, which allows taxpayers to obtain a binding opinion from the Belgian Tax Ruling Committee on tax issues and the Belgian Accounting Standards Committee on accounting issues
- The absence of capital tax and of a net wealth tax
- The deductibility of finance costs

The author acknowledges the contribution of his colleague Yannick Vandenplas.

<sup>1</sup> The Belgian branch of a foreign company can be a valuable alternative to a Belgian company because, *inter alia*, there is no dividend withholding tax (“W.H.T.”) or “branch profits tax” due on the repatriation of branch income to the head office. In most instances, however, foreign investors operate in Belgium through a subsidiary that adopts a corporate form rather than a branch. Although several corporate forms exist under Belgian corporate law, the most commonly used are the Public Limited Liability Company (S.A./N.V.) and the Limited Liability Company (S.R.L./B.V.). From a Belgian tax perspective, both the S.A./N.V. and the S.R.L./B.V. are subject to identical C.I.T. rules. The use of non-corporate entities, such as partnerships, is relatively limited.

<sup>2</sup> D.R.D. translates to *revenus définitivement taxés* or R.D.T. in French and *definitief belaste inkomsten* or D.B.I. in Dutch.

<sup>3</sup> The I.I.D. can be combined with another Belgian tax incentive that is the 80% wage W.H.T. exemption for qualifying scientific workers.

- The extensive Belgian tax treaty network
- The application of the E.U. Parent-Subsidiary Directive (“P.S.D.”) to all tax treaty countries

This chapter examines the relevant tax aspects for multinationals doing business or planning to do business with or through Belgian holding companies.<sup>4</sup> Where relevant, recent amendments to Belgian tax law are also discussed. With a statute of limitation of at least three years, historic rules remain relevant in case of a tax audit covering previous years.<sup>5</sup>

## CORPORATE INCOME TAX

### **General Regime**

Companies are subject to Belgian C.I.T. if all of the following three conditions are met:<sup>6</sup>

- They have a separate legal personality under Belgian or foreign corporate law or, if the governing foreign corporate law does not confer legal personality, they have a legal form that is comparable to a legal form that has legal personality under Belgian corporate law.
- They carry on a business or are engaged in profit-making activities.
- They have their effective place of management or control in Belgium.<sup>7</sup>

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<sup>4</sup> For the economic substance requirements in Belgium and the E.U., see W. Heyvaert *et al.*, “Economic Substance: Views From the U.S., Europe, and the B.V.I., Cayman and Nevis,” *Insights*, Vol. 10, No. 3 (2023), pp. 5-27, spec. pp. 15-23.

<sup>5</sup> When a taxpayer fails to submit their tax return or does not do so within the designated timeframe, the statute of limitation is extended to four years. In an international context, such as when taxpayers claim a foreign tax credit or seek exemptions, waivers, or reductions of W.H.T. through tax treaties or E.U. Directives, the statute of limitation is extended to six years. For cases involving alleged fraud or “complex” tax returns, such as those involving Belgian controlled foreign companies or hybrid mismatches rules, the statute of limitation is further extended to ten years. In some circumstances, the statute of limitation is even longer; this is the case, for example, when the Belgian tax authorities receive information from foreign tax authorities.

<sup>6</sup> Article 179 of the Belgian Income Tax Code (“I.T.C.”), read in parallel with Article 2, ¶1, 5°, a) and b) I.T.C.

<sup>7</sup> Although Belgian corporate law recently switched to the “statutory seat” doctrine, Belgian tax law still applies the “real seat” doctrine. When a company has its statutory seat in Belgium, it is presumed to have its real seat in Belgium, too. The company may rebut this presumption if it can establish that its tax residency is in another country in accordance with the tax legislation of that country. The concept of “effective place of management or control” or “real seat” refers to a factual situation. In practice, the real seat will be the place where the principal directors meet, where the shareholders’ meetings are held, where the ultimate management of the company takes place and where the impulse in the company is given.

**“Companies must use their standalone Belgian G.A.A.P. accounts to prepare their C.I.T. return; accounts prepared using I.A.S. or I.F.R.S. cannot be utilized for Belgian C.I.T. purposes.”**

Companies are subject to Belgian C.I.T. on their worldwide profit, including distributed dividends. The taxable income is determined on the basis of the commercial accounts and the accounting rules, unless the tax laws provide otherwise.<sup>8</sup>

Companies must use their standalone Belgian G.A.A.P. accounts to prepare their C.I.T. return; accounts prepared using I.A.S. or I.F.R.S. cannot be utilized for Belgian C.I.T. purposes.

### **Corporate Income Tax Rate**

Following a major overhaul of Belgium’s C.I.T. in 2017, the standard C.I.T. rate is 25%.<sup>9</sup>

Companies may benefit from a reduced rate of 20% for the first €100,000 of taxable income if all of the following conditions are met:<sup>10</sup>

- It qualifies as a small or medium-sized enterprise (“S.M.E.”) within the meaning of the Belgian Code on Companies and Associations (“B.C.C.A.”). The B.C.C.A. defines S.M.E.’s as companies which, on the balance sheet of the last two financial years, do not exceed more than one of the following criteria:<sup>11</sup>
  - i. An annual average of 50 employees
  - ii. Annual sales of €11.25 million, excluding V.A.T.
  - iii. A balance sheet total of €6 million
- At least 50% of the company’s shares are held by individuals.<sup>12</sup>
- It pays, from the fifth taxable period following its establishment, an annual compensation of €45,000 or more to at least one manager of the company that is a natural person. The annual compensation can be lower if it is at least equal to the company’s taxable income.<sup>13</sup>
- It is not an investment company.<sup>14</sup>
- It does not hold participations in one or more other companies that have a combined acquisition value that exceeds 50% of either the revalued paid-up capital of the company or the paid-up capital, taxed reserves, and recorded capital gains of the company. Participations of at least 75% are excluded from this calculation.<sup>15</sup>

Most Belgian holding companies will not be eligible for the reduced rate because, *inter alia*, less than 50% of their shares will be held by individuals.

<sup>8</sup> Article 24, third limb I.T.C.

<sup>9</sup> Article 215 I.T.C.

<sup>10</sup> Article 215, second limb I.T.C.

<sup>11</sup> Article 1:24 B.C.C.A.

<sup>12</sup> Article 215, third limb, 2° I.T.C.

<sup>13</sup> Article 215, third limb, 4° I.T.C.

<sup>14</sup> Article 215, third limb, 6° I.T.C.

<sup>15</sup> Article 215, third limb, 1° I.T.C.

## **Minimum Taxable Base**

Companies with a taxable profit that exceeds €1 million cannot fully benefit from certain tax attributes such as a tax loss carryforward or a D.R.D. carryforward. In the profitable year, the benefit is capped at 70% of the taxable profits in excess of €1 million.<sup>16</sup> As a result, 30% of the taxable profits that exceed €1 million in the carryforward year will be subject to the standard Belgian C.I.T. rate of 25%. The unused tax attributes can be carried forward to following taxable years until finally used. Belgian holding companies, therefore, need to re-assess their use of tax attributes and their recognition of related deferred tax assets.

## **Taxation of Dividends Received**

### **In General**

Dividends received by a Belgian company are in principle subject to the standard 25% C.I.T. rate or the reduced rate of 20% for the first €100,000 of taxable income, if applicable.

The D.R.D. regime is the Belgian implementation of the E.U. Parent-Subsidiary Directive (“P.S.D.”). Under the P.S.D., profit distributions from subsidiaries to parents established in the E.U. are, in principle, tax exempt. Member States have two options to achieve this: they can either refrain from taxing dividends received by the parent or its P.E. under the exemption method, or they can tax the dividends and allow the parent or its P.E. to deduct the tax paid by the subsidiary and any sub-subsidiaries through the credit method.

When implementing the P.S.D., Belgium chose the exemption method, but with a unique two-step system. First, the dividend received is added to the tax base of the parent. Then, after dividing the aggregate profit into three baskets – Belgian-source profit, profit exempt by virtue of a tax treaty, and profit not exempt by virtue of any tax treaty – the dividend is deducted from the Belgian tax base. However, this two-step approach can result in a less favorable tax treatment than a pure and simple exemption of the dividend in certain circumstances, which is incompatible with E.U. law. Notable cases highlighting this incompatibility include E.C.J. rulings such as *Cobelfret* (February 12, 2009, C-138/07), *KBC Bank* (June 4, 2009, C-439/07), and *Brussels Securities* (December 19, 2019, C-389/18). Currently, the Belgian D.R.D. regime is still not fully compatible with the P.S.D, particularly in cases of intragroup transfers. The most recent example of a potential incompatibility is the notorious John Cockerill case, which was referred to the E.U. Court of Justice on February 20, 2024, for a preliminary ruling.<sup>17</sup> In this case, the issue being examined is the impact of an intragroup profit transfer (the Belgian equivalent of a partial tax consolidation) on the ability of the recipient company’s right to apply the D.R.D.

### **Participation Exemption**

Dividends received by a Belgian company may be fully exempt under the D.R.D. regime if all of the following conditions are met:

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<sup>16</sup> See Article 207, fifth limb I.T.C.

<sup>17</sup> Case No. C-135/24. See [here](#).

- **Minimum Participation Value:** The recipient company owns at least 10% of the nominal share capital<sup>18</sup> of the subsidiary making the payment or the acquisition value of its holdings in the subsidiary is at least €2.5 million.<sup>19</sup>
- **Minimum Holding Period:** The recipient holds (or has committed to hold) the minimum participation referred to in the previous bullet in full ownership<sup>20</sup> for an uninterrupted period of at least one year prior to (and/or following) the dividend distribution.<sup>21</sup>
- **Subject to Comparable Tax Test:** The subsidiary making the dividend payment is subject to Belgian C.I.T. or a foreign tax similar to Belgian C.I.T.<sup>22</sup>

A foreign tax is not considered similar if the nominal or effective rate of tax is below 15%. The taxpayer may rebut this presumption.<sup>23</sup>

Tax regimes of all E.U. jurisdictions are deemed to be similar to Belgian C.I.T. even if the nominal or effective tax rate is below 15%.<sup>24</sup> Examples of countries benefiting from this rule are Ireland and Cyprus.

In contrast, countries appearing on the E.U. list of noncooperative jurisdictions will be deemed to not have a tax regime similar to Belgian C.I.T.<sup>25</sup> This list includes the following 12 jurisdictions: American Samoa, Anguilla, Antigua & Barbuda, Fiji, Guam, Palau, Panama, Russia, Samoa, Trinidad & Tobago, the U.S. Virgin Islands, and Vanuatu.

Likewise, the Royal Decree implementing the I.T.C. (“R.D./I.T.C.”) contains a list of 31 jurisdictions that are presumed to not have a tax regime similar to Belgian C.I.T.<sup>26</sup> Currently, this list includes the following jurisdictions:

|           |                  |
|-----------|------------------|
| Abu Dhabi | Maldives         |
| Ajman     | Marshall Islands |



<sup>18</sup> Under the B.C.C.A., the concept of “capital” has ceased to exist for the S.R.L./B.V. and is replaced by the concept of “equity.” Equity consists of (i) the contributions of shareholders (formerly labeled “share capital”), (ii) reserves (retained earnings), and (iii) income (profit) carried forward that serves as protection for creditors (formerly labeled “legal reserve”). For the S.A./N.V., the terminology “capital” remains applicable.

<sup>19</sup> Article 202, ¶2, first limb, 1° I.T.C.

<sup>20</sup> A *usufruct* right over the shares does not suffice. A *usufruct* right arises when full legal ownership to an asset is divided between bare legal ownership (a capital or remainder interest) and ownership of a current right to income or use. The latter is the *usufruct* right. The right exists for a limited period of time and is separate from the capital interest.

<sup>21</sup> Article 202, ¶2, first limb, 2° I.T.C.

<sup>22</sup> Article 203, ¶1, first limb, 1° I.T.C.

<sup>23</sup> Article 203, ¶1, second limb I.T.C.

<sup>24</sup> Article 203, ¶1, third limb I.T.C.

<sup>25</sup> Article 203, ¶1, first limb, 1°, *in fine*; See “Annex I – E.U. list of noncooperative jurisdiction for tax purposes” to the E.U.’s Council conclusions on the revised E.U. list of noncooperative jurisdictions for tax purposes, approved by the Eco-fin Council at its meeting on February 20, 2024.

<sup>26</sup> Article 734<sup>quater</sup> R.D./I.T.C.



*“The minimum participation value and minimum holding period requirements do not need to be fulfilled with respect to shares held in or by investment companies and regulated real estate companies.”*

|                      |                |
|----------------------|----------------|
| Andorra              | Micronesia     |
| Bosnia & Herzegovina | Moldova        |
| Dubai                | Monaco         |
| East Timor           | Montenegro     |
| Gibraltar            | Oman           |
| Guernsey             | Paraguay       |
| Isle of Man          | Qatar          |
| Jersey               | Ras al Khaimah |
| Kosovo               | Serbia         |
| Kuwait               | Sharjah        |
| Kyrgyzstan           | Turkmenistan   |
| Liechtenstein        | Umm al Qaiwain |
| Macau                | Uzbekistan     |
| Macedonia            |                |

Countries appearing on this R.D./I.T.C. list may still pass the subject-to-tax test if the taxpayer is able to rebut the presumption. For example, due to the recent increase of the C.I.T. rate to 15% in Serbia, taxpayers may argue that Serbian-source dividends qualify for the D.R.D. despite appearing on the list.<sup>27</sup>

- **Specific Anti-Abuse Rule:** The D.R.D. is not available for dividends stemming from a company that distributes income related to a legal act or a series of legal acts that the Belgian tax authorities have determined are not genuine, and have as their main goal or one of their main goals the attainment of the deduction or one of the benefits of the P.S.D. in another E.U. Member State.<sup>28</sup> The determination is to be based on all relevant facts, circumstances, and proof to the contrary. Actions will be considered “not genuine” if they are not taken for valid commercial reasons that reflect economic reality. This rule is separate from Belgium’s general anti-abuse provision.

The minimum participation value and minimum holding period requirements do not need to be fulfilled with respect to shares held in or by investment companies and regulated real estate companies.<sup>29</sup> Dividends and capital gains derived from these shares are fully exempt, irrespective of the size or duration of the investment, provided the subject to tax test is met.

### Exceptions to the Participation Exemption

#### Finance, Treasury and Investment Companies

The D.R.D. is not available for dividends distributed by a finance company, a treasury company or an investment company where the company enjoys a tax regime that deviates from the normal tax regime in its country of residence.<sup>30</sup>

<sup>27</sup> See Ruling No. 2016.740 of November 29, 2016, available on [www.monkey.be](http://www.monkey.be).

<sup>28</sup> Article 203, ¶1, first limb, 7° I.T.C.

<sup>29</sup> Article 202, ¶2, third limb I.T.C.

<sup>30</sup> Article 203, ¶1, first limb, 2° I.T.C.

A company is a finance company if its sole or principal activity consists of providing financial services to unrelated parties (*i.e.*, parties that do not form part of a group to which the finance company belongs).<sup>31</sup> Financial services include the provisions of financing and financial management. Belgian companies are part of the same group if one company exercises control over the others, if two companies are controlled by a common parent company, or if they constitute a consortium.<sup>32</sup>

A treasury company is a company that is principally engaged in portfolio investment other than cash pooling.<sup>33</sup>

An investment company is a company whose purpose is the collective investment of capital funds. Examples are companies that qualify as S.I.C.A.V.'s or S.I.C.A.F.'s.<sup>34</sup>

Nonetheless, the D.R.D. is available under certain conditions for E.U.-based finance companies and for investment companies.<sup>35</sup>

### Regulated Real Estate Companies

The D.R.D. is not available for dividends derived from a Belgian regulated real estate company, which is the functional equivalent of a real estate investment trust ("R.E.I.T.").<sup>36</sup> The same rule applies to a nonresident company if all of the following conditions are met:

- The main purpose of the company is to acquire or construct real estate property and make it available on the market, or to hold participations in entities with a similar purpose.
- The company is required to distribute part of its income to its shareholders.
- The company benefits from a regime that deviates from the normal tax regime in its country of residence.

### Offshore Activities

The D.R.D. is not available for dividends distributed by a company when the non-dividend income of that company originates in a third country and such income is subject to a separate tax regime that provides more favorable results than the regular tax regime.<sup>37</sup>

### Certain Foreign Branch Income

The D.R.D. is not available when the dividends are distributed by a company that realizes profits through a foreign branch that is subject to a tax regime substantially

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<sup>31</sup> Article 2, ¶1, 5°, d) I.T.C.

<sup>32</sup> See Article 2, ¶1, 5°/1, which refers to Article 1:20 B.C.C.A.

<sup>33</sup> Article 2, ¶1, 5°, e) I.T.C.

<sup>34</sup> Article 2, ¶1, 5°, f) I.T.C.

<sup>35</sup> See Article 203, ¶2 I.T.C.

<sup>36</sup> Article 203, ¶1, first limb, 2°bis I.T.C.; For further details on the tax regime of Belgian Regulated Real Estate Companies, see P. Desenfans et L. Pinte, "Aspects fiscaux des SIR et FIIS," *Jurim pratique*, 2017/3, pp. 189-221.

<sup>37</sup> Article 203, ¶1, first limb, 3° I.T.C.

more advantageous than in Belgium.<sup>38</sup> This disallowance rule is, in turn, subject to an exception. The D.R.D. will be allowed for dividends distributed by (i) Belgian companies with foreign branches or (ii) companies established in certain treaty jurisdictions and that operate through a branch in a third country.

Dividends stemming from non-Belgian branch profits qualify for the D.R.D. to the extent that either the branch profits are subject to a 15% foreign income tax, or the branch is located in another E.U. jurisdiction.<sup>39</sup>

### Intermediate Companies

Subject to a 10% *de minimis* rule, the D.R.D. is not available for dividends distributed by an intermediate company, other than an investment company, that redistributes dividend income derived from tainted participations.<sup>40</sup> As a result, if more than 10% of a dividend received from an intermediate company is funded by the receipt of dividends from its subsidiaries located in third countries, the D.R.D. may be disallowed if the D.R.D. would not have been permitted had the lower-tier companies paid dividends directly to the Belgian company. In other words, a group cannot cleanse tainted dividends by washing them through an intermediary located in an “acceptable” jurisdiction.

As a safe harbor, participations in companies (i) residing in a country with which Belgium has concluded an income tax treaty or (ii) that are listed on a recognized E.U. stock exchange are in principle eligible for the D.R.D.<sup>41</sup> These companies must also be subject to a tax regime comparable to the Belgian tax regime, without benefiting from a regime that deviates from the normal tax regime.<sup>42</sup>

With respect to investments in a second-tier subsidiary through a hybrid entity such as a U.S. limited liability company (“L.L.C.”), the Belgian Ruling Committee issued several favorable rulings. In most instances, the Ruling Committee confirmed that, for Belgian tax purposes, one can look through a foreign hybrid entity to allow the D.R.D. as if the underlying participation in a lower-tier company were held directly by the Belgian holding company. Thus, for example, in a ruling dated February 12, 2019, the Ruling Committee found that a Belgian company was entitled to the D.R.D. with respect to dividends received from a U.S. L.L.C.<sup>43</sup> The Ruling Committee looked to paragraph 1(b) of Article 22 (Relief From Double Taxation) of the Belgium-U.S. Income Tax Treaty and ruled that the Belgian company was entitled to the D.R.D. to the extent that such dividends stemmed from dividends received by the L.L.C. from a U.S. operating corporation that was subject to full corporate income tax in the U.S.

In the same ruling, the Ruling Committee confirmed that the proceeds of a redemption of capital that is received by an L.L.C. and in turn distributed to a Belgian company was plainly exempt from Belgian C.I.T. by virtue of Article 18, second limb,

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<sup>38</sup> Article 203, ¶1, first limb, 4° I.T.C.

<sup>39</sup> Article 203, ¶2, seventh limb I.T.C.

<sup>40</sup> Article 203, ¶1, first limb, 5° I.T.C.

<sup>41</sup> Article 203, ¶2, eighth limb, 1° I.T.C.

<sup>42</sup> Article 203, ¶3 I.T.C.

<sup>43</sup> Ruling No. 2018.0085 of February 12, 2019, available on <http://www.monkey.be>.

I.T.C. when the underlying U.S. company owned by the L.L.C. is subject to full tax in the U.S. Article 18 I.T.C. defines the term “dividend.” Excluded from the scope of that definition is any return of share capital, provided the corporation that makes a distribution in return of share capital complied with the relevant company law rules. No requirement exists to test the quantitative or qualitative conditions of the D.R.D. under Belgian domestic law or an income tax treaty.<sup>44</sup>

### Dividend Payments that are Deductible for the Payor

The D.R.D. is not applicable to dividend income received from a company that has deducted or can deduct such income from its profits.<sup>45</sup>

### Ruling Practice

Upon a taxpayer’s request, the Belgian Ruling Committee may issue an advance tax ruling on various items such as the availability of the D.R.D., the capital gains exemption, the application of anti-abuse provisions and the qualification of a company as resident or nonresident taxpayer. Although a ruling is not mandatory, it is frequently used by multinational groups to obtain legal certainty.

In theory, the Ruling Committee issues the ruling within three months following the receipt of a complete ruling application. In practice, however, the actual term is assessed on a case-by-case basis within 15 days following the filing of the ruling application.

Subject to conditions, a ruling is valid for a maximum of five years. If justified, a ruling can be granted for a longer period. Rulings can also be renewed.

Effective May 2019, the Belgian Accounting Standards Committee issues rulings on the application of accounting law rules. In the absence of a tax rule that differs from an accounting rule, Belgian tax law follows Belgian accounting practice. It is understood that Belgian corporate income tax is based on the taxpayer’s Belgian G.A.A.P. accounts, even if the taxpayer is part of a group filing consolidated accounts under I.F.R.S. (or any other set of consolidation rules). The availability of accounting law rulings may prove useful in practice.

### Taxation of Dividends Received in a Year Having Operating Losses

Prior to assessment year 2009, if a Belgian company’s activities other than serving as a holding company for its subsidiaries resulted in a loss in the current year, the loss was used to offset dividend income. As a result, the benefit of the loss carryover was reduced or even completely eliminated. Moreover, the unused portion of the D.R.D. was permanently lost.

This position was challenged in an appeal to the European Court of Justice (“E.C.J.”) in *Cobelfret v. Belgium* (Case C-138/07).<sup>46</sup> On February 12, 2009, the



<sup>44</sup> Note that under U.S. tax law, not all distributions that return share capital are treated as a redemption giving rise to capital gain treatment under U.S. tax law. Under Section 302 of the Internal Revenue Code, a distribution in return of capital – typically referred to as a redemption under U.S. tax jargon – is treated in some circumstances as a redemption and in others as a dividend.

<sup>45</sup> Article 203, ¶1, first limb, 5° I.T.C.

<sup>46</sup> E.C.J., *Belgische Staat v. Cobelfret N.V.*, Case C-138/07, February 12, 2009, available at <http://www.curia.europa.eu>.

E.C.J. concluded that Belgium failed to refrain from taxing qualifying dividends, as is required under Article 4(1) of the E.U. P.S.D. Two other cases were decided by “reasoned order” of the E.C.J. on June 4, 2009.<sup>47</sup> These cases dealt with E.U.-source dividends, Belgian domestic dividends, and dividends from countries outside of Europe. The E.C.J. asked the national courts to decide whether discrimination existed in the treatment of nonresident taxpayers when compared with resident taxpayers. This triggered an amendment to the statute by the Law of December 21, 2009, effective January 1, 2010. The net effect is that the unused portions of the D.R.D. 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 any of the following jurisdictions:

- A Member State of the European Economic Area (“E.E.A.”), including Belgium
- A country with which Belgium has concluded a 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)
- Another country, provided that Article 63 of the Treaty on the Functioning of the European Union (“T.F.E.U.”) (free movement of capital) applies – to the capital represented by the shares that produce the dividends

Non-E.E.A. source dividends remain unaffected by the E.C.J. Cobelfret case. Consequently, the unused portion of the D.R.D. cannot be carried forward.<sup>48</sup>

In addition, Belgium disallows the D.R.D. to the extent that a Belgian company’s taxable income (*i.e.*, profit) reflects certain nondeductible expenses.<sup>49</sup> However, the disallowance does not apply to dividends stemming from qualifying subsidiaries established in a Member State of the E.E.A.<sup>50</sup>

Where the facts of a particular case involving dividends from a company meet none of the foregoing criteria, the law remains unfavorable for taxpayers. According to a ruling of February 1, 2011, from the Court of First Instance in Brussels,<sup>51</sup> the rule that excess dividends cannot be carried over if they stem from subsidiaries in non-E.E.A. countries with which Belgium does not have an income tax treaty in force containing an equal treatment provision does not run afoul of the Belgian constitutional non-discrimination rule.

In the facts addressed by the Brussels Court, the tax administration allowed a taxpayer to carry over excess dividends from a Japanese subsidiary of a Belgian holding company because an equal treatment provision is provided in Article 23(2)(a) of the Belgium-Japan Income Tax Treaty. However, the tax administration refused to allow the carryover of Taiwanese and South Korean dividends, because the treaties

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<sup>47</sup> E.C.J., *Belgische Staat v. KBC Bank N.V. and Beleggen, Risicokapitaal*, Joined Cases C-439/07 & C-499/07, June 4, 2009, available at <http://www.curia.europa.eu>.

<sup>48</sup> Article 205, ¶3, *a contrario* I.T.C.

<sup>49</sup> Article 205, ¶2, first limb I.T.C.

<sup>50</sup> Article 205, ¶2, second limb I.T.C.

<sup>51</sup> Court of First Instance in Brussels, February 1, 2011, R.G. 2009/1652/A, available on [www.monkey.be](http://www.monkey.be).

with those jurisdictions did not contain an equal treatment clause. Before the Brussels Court, the taxpayer claimed that the foregoing distinction ran afoul of the Belgian nondiscrimination rule of Article 10 in conjunction with Article 172 of the Belgian Constitution. However, the Tribunal sided with the tax administration, concluding that the distinction between an E.E.A.-source dividend and a “third country dividend” is based upon an objective criterion, and for that reason, is permissible.

In a similar case decided on October 10, 2012, the Belgian Constitutional Court confirmed that the carryforward or denial of the participation exemption for excess dividends from companies organized in third countries not having bilateral tax treaties with equal treatment clauses does not constitute a violation of the constitutional nondiscrimination principle.<sup>52</sup>

In sum, the unused portion of D.R.D. for E.E.A. source dividends can be carried forward following the E.C.J.’s Cobelfret case discussed above. Conversely, the D.R.D. for non-E.E.A. source dividends remains subject to a double restriction:

- The D.R.D. cannot apply to certain nondeductible expenses (e.g., the nondeductible portion of restaurant expenses).<sup>53</sup>
- The unused portion of the D.R.D. cannot be carried forward.<sup>54</sup>

Say a Belgian company (“BelCo”) has (i) a non-E.E.A. source dividend of €50, (ii) a current year loss of €20, and (iii) nondeductible restaurant expenses of €10.

Before applying the D.R.D., the taxable base of BelCo is €40 (50-20+10). If the dividend of €50 meets the conditions for the D.R.D., the D.R.D. will apply only to €30 (40 of net income - 10 of nondeductible expenses), leaving a taxable base of €10 (40-30).

The unused portion of the D.R.D. (50-20 = 30) will be forfeited, as the dividend is from a non-E.E.A. source and thus cannot be carried forward, unless the dividend stems from a participation based in a country having a bilateral treaty in force with Belgium and which contains an equal treatment clause.

## **Taxation of Capital Gains on Shares**

### **Taxation of Realized Capital Gains on Shares**

Capital gains on shares realized by a Belgian company are in principle taxed as ordinary profits and subject to the standard 25% C.I.T. rate or the reduced rate of 20% for the first €100,000 of taxable income, if applicable.

By way of exception, a full exemption is applicable provided that the participation, holding period and subject-to-tax requirements applicable for the D.R.D. are met (see conditions above).<sup>55</sup> The exemption applies only to the net gain realized, *i.e.*,

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<sup>52</sup> Belgian Constitutional Court, October 10, 2012, R.G. 118/2012, available at <http://www.const-court.be>.

<sup>53</sup> See Article 205, ¶2, first limb I.T.C. for the complete list.

<sup>54</sup> Article 205, ¶3, *a contrario* I.T.C.

<sup>55</sup> Article 192, ¶1 I.T.C.; The minimum participation requirement does not apply to insurance and reinsurance companies that hold participations to hedge their liabilities.

the amount after the deduction of the alienation costs (e.g., notary fees, bank fees, commissions, publicity costs, consultancy costs, etc.).<sup>56</sup>

The fact that, as of assessment year 2019 (accounting years ending on or after December 31, 2018), the capital gain exemption is fully synchronized with the D.R.D. has important consequences in the following cases:

### The “One Taints All” Principle

Prior to assessment year 2019, capital gains on the disposal of a share package containing a tainted share (*i.e.*, a share that did not qualify for the D.R.D.) were not exempt. After the reform, it is clear that a proportional exemption is possible, similar to the rules for the D.R.D.

### Disposal of Part of a Qualifying Participation

Assume that a taxpayer has a qualifying participation of more than 10% or €2.5 million and that only a part of that participation is sold or otherwise disposed of. Any gain on this sale qualifies for the capital gain exemption.

However, it is not entirely clear whether the exemption will be available when the remainder of the participation is sold at a later time. If the remaining shareholding has an historic book value of at least €2,500,000 or constitutes a participation of at least 10%, the exemption should be available. On the other hand, if the remaining shareholding has dropped below both the 10% and the €2,500,000 thresholds, any gain on the sale of the remaining shareholding will likely fail the minimum participation test and, therefore, not be exempt.

### Exchange of Shares

Subject to certain conditions, when a Belgian company transfers shares in a Belgian or European target company to a European acquiring company in exchange for issuance of new shares of the acquiring company, any gain resulting from the share-for-share exchange is temporarily exempt under the E.U. Merger Directive by virtue of a roll-over rule. As a result, it is possible in principle to exchange tainted shares for untainted shares. After the exchange, a company could request the exemption for capital gains on shares as described above. To stop this practice, the Belgian legislature has implemented a specific anti-abuse provision limiting the exemption to the capital gains that accrue after the exchange of shares. This provision applies only to shares that do not meet the valuation standard for exemption. Why the holding and/or participation requirements are not also subject to this provision is unclear and may lead to its improper use.

### Minimum Requirements

The minimum participation requirements that exist for dividends – ownership of 10% of the capital, or an acquisition value of the shareholding of not less than €2.5 million – also apply to capital gains.<sup>57</sup>

In the past, uncertainty existed regarding the D.R.D. where the shares were acquired by a Belgian holding company at a price or value that was far below their

<sup>56</sup> Article 43 I.T.C.

<sup>57</sup> See Article 192, ¶1 I.T.C., which refers back to Articles 202-203.



actual value at the time of acquisition. The position of the Belgian tax authorities was that the difference between the artificially low acquisition price and the high actual value as of the date of acquisition should be booked as an undervaluation of assets and taxed as regular income of the holding company. The income would be deemed to accrue in the year of acquisition. It would be taxed retroactively at the full C.I.T. rate of 25%.

This position was successfully challenged in the *Gimle* case<sup>58</sup> in a preliminary ruling from the E.C.J. that was settled definitively by the Court of Cassation.<sup>59</sup> Going forward, the full gain based on the low purchase price is exempt.

### Operation of the Capital Gains Exemption

The capital gains exemption is granted by a direct elimination of the net gain from taxable income. Consequently, loss utilization is not adversely affected.

Losses derived from other activities of the Belgian holding company, including interest and other costs or expenses related to the acquisition of the participation, are not allocated to the exempt gain.

This treatment should be compared to the treatment of costs and expenses relating to the sale of shares. This is discussed below.

### Options

If a Belgian company purchases stock below fair market value pursuant to the exercise of a call option or a warrant, any subsequent gains realized upon the disposition of the shares of stock qualify in principle as fully exempt capital gains, provided all conditions provided in Belgian law are met. The exemption does not apply to gains derived from the sale of the option or the warrant as such. If the call option itself were sold at a gain reflecting the appreciation of the value of the underlying share, the gain would be subject to the regular C.I.T. rate.

Note, however, that the law of December 1, 2016 introduced specific anti-abuse provisions applicable to the D.R.D., the capital gains exemption, and the W.H.T. exemption for parent companies. These rules are in addition to Belgium's general anti-abuse provision. Transposing the revisions to the P.S.D. issued by the European Commission ("Commission"), taxpayers must have appropriate business motives for the implementation of a holding structure, as previously discussed.

### Taxation of Unrealized Capital Gains on Shares

Unrealized capital gains are not taxable if the capital gains are not reflected in the company's financial accounts. There are no mark-to-market rules under Belgian G.A.A.P. Even if reported, the unrealized gain is not taxable if and as long as it is booked in a non-distributable reserve account.<sup>60</sup> Upon later realization of the gain, the non-distributable reserve account disappears without triggering C.I.T., assuming

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<sup>58</sup> E.C.J., *Belgium v. Gimle S.A.*, Case-322/12 of October 3, 2012, ECLI:EU:C:2013:632, spec. ¶39.

<sup>59</sup> Court of Cassation, May 16, 2014, R.G. F.10.0092.F., available at [www.monkey.be](http://www.monkey.be).

<sup>60</sup> Article 24, first limb, 2° I.T.C. read in parallel with Article 44, ¶1, 1° and 190, second and fourth limbs.



all conditions for the capital gains exemption are met at that time.

### Taxation of Realized and Unrealized Capital Losses on Shares

Capital losses on shares, whether realized or unrealized, are not tax deductible.<sup>61</sup> However, the loss incurred in connection with the liquidation of a subsidiary company remains deductible up to the amount of lost paid-up share capital.

The nondeductible nature of a capital loss is limited to shares. Capital losses realized on other securities (e.g., bonds) or derivatives (e.g., options) are fully tax deductible.

## WITHHOLDING TAX ON DIVIDEND DISTRIBUTIONS

### To Belgium

Dividends distributed by a non-Belgian company to a Belgian company may be subject to dividend W.H.T. at the rate in effect in the country of residence of the company paying the dividend. In most situations, this rate is reduced or eliminated by a tax treaty or the P.S.D.

With the exception of investment companies, Belgium's national law does not grant a tax credit for foreign W.H.T. imposed on dividends.<sup>62</sup> However, certain bilateral tax treaties provide a Foreign Tax Credit ("F.T.C.") trumping the Belgian national law provisions. For instance, the Belgian Court of Cassation ruled on October 15, 2020, that the Belgian tax authorities cannot invoke national provisions to deny Belgian taxpayers the benefit of the 1964 Belgium-France tax treaty.<sup>63</sup>

### From Belgium

#### General Rule

As a general rule, dividends distributed by Belgian companies to resident and non-resident shareholders are subject to 30% Belgian dividend W.H.T.<sup>64</sup> Under specific circumstances, reduced rates or exemptions are available.

A full exemption of Belgian dividend W.H.T. applies on the payment of dividends to a parent company established within the E.E.A. (including Belgium) or in a country with which Belgium has concluded a tax treaty containing an exchange of information provision.<sup>65</sup> In both instances, the shareholder must hold (i) a participation of

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<sup>61</sup> Article 198, ¶1, 7° I.T.C.

<sup>62</sup> Article 285, second limb I.T.C.

<sup>63</sup> Court of Cassation, October 15, 2020, R.G. F.19.0015.F, *F.J.F.*, 2020/10, pp. 365-366; Note that Belgium has recently signed a new tax treaty with France on November 9, 2021. In this respect, see P.-J. Wouters, "The Belgium-France Income and Capital Tax Treaty (2021): What's New?" *Bulletin for International Taxation*, 2022, Vol. 76, No 3, pp. 159-167.

<sup>64</sup> Article 261, 1° I.T.C. and Article 269, ¶1, 1° I.T.C.

<sup>65</sup> Article 106, ¶¶5-6bis R.D./I.T.C.; Belgian tax authorities take the view that the agreement between Belgium and Taiwan does not qualify as a tax treaty. Therefore, the full dividend W.H.T. exemption for dividends distributed by a Belgian

**“The legal form requirement does not apply if dividends are paid to Belgian entities subject to Belgian C.I.T.”**

at least 10% of the Belgian-resident company or an acquisition price or value of at least €2.5 million and (ii) the participation must have been held for an uninterrupted period of at least one year, which may occur partly before and partly after the dividend distribution. Once a qualifying parent company holds a qualifying participation, all additional acquired shares also qualify, even if the one-year holding period is not met with respect to the additional shares.

### Less-Than-10% Investments

Following the ruling from the E.C.J. in the *Denkavit* case,<sup>66</sup> Belgium abandoned the condition that the parent must have held a participation of at least 10% for an uninterrupted 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 hurdle is not fully met 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 W.H.T. that would apply if the one-year holding period is not respected, thereby taking into account any treaty-based reductions that would be available if the one-year holding period is not met), without an actual payment to the Belgian tax authorities for the notional tax retained. If the shares are sold prior to meeting the holding period requirement, the amount of W.H.T. becomes due, increased by interest for late payment of tax. Otherwise, the undistributed portion of the dividend can be distributed freely once the one-year holding requirement is met.

The exemption from dividend W.H.T. is subject to the conditions mentioned in the P.S.D. with respect to the legal form, E.U. tax residence, and the parent company's compliance with a subject-to-tax requirement.<sup>67</sup> As a result of the amendment of the P.S.D., several types of entities that were not eligible for the W.H.T. exemption now qualify, most notably the “European company” or “*societas Europaea*” (“S.E.”). The legal form requirement does not apply if dividends are paid to Belgian entities subject to Belgian C.I.T.

Corporate investors established in other E.E.A. Member States would be subject to double taxation if they held a participation in a Belgian company that was less than 10% but had an acquisition price or value of at least €2.5 million. Under these circumstances, a Belgium-resident corporate shareholder would be entitled to the D.R.D., which amounts to 100% as of January 1, 2018, and be allowed a full credit and refund for Belgian dividend tax withheld at source. In comparison, prior to January 1, 2018, the €2.5 million threshold did not apply for the exemption from dividend W.H.T., meaning that a non-Belgian E.E.A. shareholder with an interest below 10% but an acquisition price or value of at least €2.5 million was subject to Belgian

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company will not be available to the extent such dividends are distributed to a Taiwanese parent company.

<sup>66</sup> E.C.J., *Denkavit Internationaal B.V. and Denkavit France S.A.R.L. v. France*, December 14, 2006, Case C-170/05, available at <http://www.curia.europa.eu>. Note that this is the second case involving the Denkavit company; the first one (C-283/94, October 17, 1996) also concerned the treatment of dividends, the application of the P.S.D. and the calculation of the two-year minimum holding period required to benefit from the participation exemption.

<sup>67</sup> See Article 106, ¶15 R.D./I.T.C.

W.H.T. on any dividends received from its Belgian participation.<sup>68</sup> If the shareholder was not entitled to claim a foreign tax credit in its country of residence, the Belgian dividend was subject to double international taxation.

To remedy this unequal treatment, the Law of December 25, 2017, introduced a new dividend W.H.T. exemption. New Article 264/1 I.T.C. alleviates the participation requirement effective as of January 1, 2018. If the participation does not satisfy the 10% test, dividends can still be exempt from W.H.T. if the E.E.A.-based corporate shareholder owns a participation in the Belgian distributing company with a tax book value of at least €2.5 million for an uninterrupted period of at least one year (prior to and/or immediately after the distribution of the dividend). To curb any potential abuses, the new exemption does not apply if, *inter alia*, the beneficiary of the dividend is entitled to credit Belgian dividend W.H.T. against its mainstream tax liability and receive a full refund of any excess W.H.T. in the E.E.A. Member State where it is based. In addition, the beneficiary must certify that it meets the other P.S.D. criteria, e.g., that it has a legal form listed in the Annex to the P.S.D. and that it is subject to the normal C.I.T. regime in the other Member State.

This provision also introduces an exemption for Belgian companies distributing a dividend to a non-E.E.A. based shareholder who (i) is based in a country with which Belgium has concluded a tax treaty containing an exchange of information provision and (ii) owns a participation below 10% in the Belgian company but with an investment price or value of at least €2.5 million.

#### Liquidation/Redemption Distributions to Persons Not Entitled to the Participation Exemption

The W.H.T. rate is set at 30% if dividends result from a redemption of shares or a share buy-back.

Distributions pursuant to liquidations and redemptions are subject to 30% Belgian dividend W.H.T., but may be eligible for rate reductions or exemptions from W.H.T. under a tax treaty concluded by Belgium, the P.S.D., or the unilateral extension of the P.S.D. W.H.T. exemption discussed above.

Through December 2017, any repayment of share capital or share premium to the shareholders was exempt from dividend W.H.T., provided that the repaid capital consisted of paid-up fiscal capital, did not consist of reserves, and the reduction of capital was executed in accordance with the old Belgian Company Law Code (now replaced by the B.C.C.A.).

In order to combat certain abusive “step-up” structures, the Law of December 25, 2017, introduced a relatively complex set of rules governing the reduction and reimbursement to shareholders of fiscal share capital.<sup>69</sup> From January 1, 2018, any reduction of share capital, including qualifying share premium, will be deemed to

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<sup>68</sup> Since January 1, 2018, Article 264/1, ¶1, second limb I.T.C. allows non-Belgian E.E.A. shareholders with an interest below 10% but with an acquisition price or value of at least €2.5 million to benefit from a full dividend W.H.T. exemption.

<sup>69</sup> Fiscal share capital is any portion of a company’s equity that stems from actual contributions in cash or in kind made to the company by its current or past shareholders. It excludes any earnings and profits of the company that were converted to share capital for legal and accounting purposes but did not stem from contributions made by shareholders.

be paid proportionally from (i) fiscal share capital and share premium and (ii) profits carried forward or retained earnings. Only insofar as the capital reimbursement is deemed to be paid from fiscal share capital and share premium will no dividend W.H.T. apply. The portion of such reimbursement that is deemed to stem from profits carried forward and retained earnings will be treated as a regular dividend subject to the rules for regular dividend distributions, as discussed above.

### **Abuse of European Union's Directives**

In February 2019, the E.C.J. ruled in the so-called Danish cases (Joined Cases C-116/16 and C-117/16) that the explicit transposition of the anti-abuse provisions of the E.U. Directives into national legislation or income tax treaties is not necessary to deny the benefits of these Directives in abusive situations.<sup>70</sup> For the E.C.J., there is, *inter alia*, an indication of abuse when:

- the recipient lacks substance, has no other economic activity in the country or has been interposed in a structure that otherwise would not be covered by the E.U. Directives; or
- the funds are passed on shortly after they are received, which indicates that the entity might be a mere flow-through or conduit to the ultimate recipient.

In December 2020, the Belgian Court of Appeals of Ghent endorsed the E.C.J.'s Danish cases doctrine and earmarked as abusive a W.H.T. exemption applied by a Belgian company distributing dividends to a Luxembourg S.P.V., because of the lack of substance in Luxembourg in combination with the artificial character of a number of steps in the transaction that was at stake.

## **TAX TREATMENT OF BORROWING AND INTEREST PAYMENT**

In principle, interest expense incurred by a company is tax deductible. However, limitations apply to the deduction.

### **General Expense Deduction Rule**

Like other costs and expenses, interest expenses are deductible by a company to the extent they<sup>71</sup>

- relate to the company's business activities,
- are incurred or borne during the taxable period,
- were incurred with a view to producing or maintaining taxable income, or
- are subject to proper documentation being provided.

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<sup>70</sup> For further details about the Danish cases, see W. Heyvaert *et al.*, "Economic Substance: Views From the U.S., Europe, and the B.V.I., Cayman and Nevis." *Insights* Vol. 10, No. 3 (2023), pp. 5-27, spec. pp. 16-19; see also S. Baerentzen, "Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?" *World Tax Journal*, 2020, Vol. 12, No 1, pp. 3-52.

<sup>71</sup> Article 49 I.T.C.

## **General Interest Limitation Rule (Arm’s Length Principle)**

Companies can deduct interest expenses to the extent they correspond to a market interest rate, taking into account the specific characteristics of the financing.<sup>72</sup> These include the currency exchange risk, the debtor’s credit rating or creditworthiness, the duration of the loan, the timing of interest payments, the reimbursement of principal, and any collateral held as security by the lender.

If the interest charged between two related parties exceeds the interest charged in a comparable transaction between two unrelated parties, any excessive interest payment is not tax deductible by the borrower. If excessive interest paid or accrued by the borrower is not reported in the company’s annual C.I.T. return, but rather added to its tax base as a result of a tax examination by Belgian tax authorities, the excessive interest deduction will be earmarked as an “abnormal or gratuitous advantage” and taxed currently without being eligible for a set-off by reason of a loss that is available for carryover from an earlier year or other deductions.<sup>73</sup>

### **Interest Payments to Tax Exempt/Low Taxed Non-E.U. Residents**

If a Belgian company pays interest to a nonresident who is either not subject to tax or who benefits from a tax regime notably more advantageous than the Belgian tax regime, such interest would not be tax deductible unless and to the extent the Belgian company can demonstrate that the interest payment (i) does not exceed the normal limits, *i.e.*, the interest rate is at arm’s length and (ii) relates to real and sincere operations, *i.e.*, the loan is neither fictitious nor simulated and is entered into for genuine business, commercial or financial purposes.<sup>74</sup>

It is not required that the borrower has a need to borrow; the borrower is free to choose how it finances its business with shareholder equity, related party debt, or third-party debt. However, the borrower has the burden of demonstrating that the two conditions set forth above are met.

In principle, this rule is applicable to interest paid by Belgian companies to any nonresident who is exempt from tax or subject to a beneficial tax regime on the interest earned. However, in the *S.I.A.T.* case (C-318/10), the E.C.J. ruled that this rule infringes the European freedom to provide services, to the extent the application of the rule treats (i) interest paid to Belgian residents more favorably – not subject to the reversal of burden of proof-rule – than (ii) interest paid to other E.U. residents – subject to the reversal of burden of proof-rule.<sup>75</sup> As a result, it is generally understood that the two-prong rule described above, including the burden of proof element, applies only to interest paid or owed to non-E.U. residents.

Another rule provides that interest paid by Belgian companies to a beneficiary established in a jurisdiction listed as a tax haven for Belgian tax purposes would be tax deductible only to the following extent:<sup>76</sup>

<sup>72</sup> Article 55 and 56 I.T.C.

<sup>73</sup> Article 206/3, ¶1 I.T.C.

<sup>74</sup> Article 54 I.T.C.

<sup>75</sup> E.C.J., *S.I.A.T. v. Belgium*, July 5, 2012, Case C-318/10, available at <http://www.curia.europa.eu>.

<sup>76</sup> Article 198, ¶1, 10° I.T.C.

***“It is not required that the borrower has a need to borrow; the borrower is free to choose how it finances its business with shareholder equity, related party debt, or third-party debt.”***

- The Belgian company establishes that the interest relates to “genuine and sincere operations” (as defined herein above) with persons other than artificial constructs.
- The Belgian company reports the payment in an annex to its C.I.T. return.

This rule does not apply in either of two instances. The first is that the payment does not exceed €100,000 for a taxable period. The second is that the interest is paid to a non-E.U. person resident in a state with which Belgium has signed an income tax treaty containing a nondiscrimination clause or an automatic exchange of information clause.

## **E.B.I.T.D.A Limitation Rule**

### **In General**

Belgium implemented Article 4 of the E.U. Anti-Tax Avoidance Directive (“A.T.A.D.”) into its national law. Therefore, companies are allowed to deduct excess borrowing cost only to the extent it does not exceed a cap.<sup>77</sup> Excess borrowing cost refers to an entity’s net funding cost, consisting of the difference between interest paid or accrued under its accounting method over interest received or accrued and recognized under its accounting method.<sup>78</sup> The excess borrowing cost is capped at €3 million or 30% of the E.B.I.T.D.A. computed for income tax purposes, whichever is greater. The cap is referred to frequently as “fiscal E.B.I.T.D.A.”

### **Fiscal E.B.I.T.D.A.**

The computation of fiscal E.B.I.T.D.A. begins with taxable profit. After that, several tax-technical corrections are made, which can be divided into two groups. The first group of corrections adds back to the taxable profit amortization deductions, depreciation deductions, and the amount of excess interest expense over interest income.<sup>79</sup> The second group of corrections removes, *inter alia*, income to which the D.R.D., the I.I.D., or an F.T.C. applies, the intragroup profit transfer, or the profit relating to a qualifying long-term public infrastructure project.<sup>80</sup> This reflects the view that exempt income is removed when computing fiscal E.B.I.T.D.A.

### **Exclusions**

The fiscal E.B.I.T.D.A. limitation rule for interest expense deductions does not apply to any of the following:

- Income from financial operations of banks, insurance companies, pension funds, leasing companies, and factoring companies

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<sup>77</sup> Article 198/1 I.T.C.

<sup>78</sup> See Article 734/8 R.D./I.T.C. that provides a description of income and expenses that are “economically equivalent to interest,” e.g., payments under profit participation loans, capitalized interest, foreign exchange gains/losses related to interest payments, guarantee provisions, discount on interest-free or abnormally low-interest loans.

<sup>79</sup> Article 198/1, ¶3, second limb I.T.C.

<sup>80</sup> Article 198/1, ¶3, third limb I.T.C.

*“Taxpayers can carry forward the excess borrowing costs that cannot be deducted during a financial year to a subsequent financial year or transfer them to another Belgian group entity.”*

- Income of standalone entities, essentially taxpayers without a foreign P.E. and without affiliates having a direct or indirect shareholding link of at least 25%
- Public-private partnership projects, essentially long-term public infrastructure projects

The following three types of loans are also out of scope:

- Loans concluded before June 17, 2016, unless fundamental changes have been made to the terms and conditions after that date<sup>81</sup>
- Loans in relation to public-private cooperation projects
- Loans between Belgian entities that are part of the same group, as discussed in more detail, below

### Carryforward

Taxpayers can carry forward the excess borrowing costs that cannot be deducted during a financial year to a subsequent financial year or transfer them to another Belgian group entity.<sup>82</sup>

### Group Application

Belgian entities that are part of a group must share the interest deduction cap among themselves.<sup>83</sup> The allocation may be computed on a per capita basis among all members or in proportion to the level of the respective excess borrowing costs of each member. In the latter instance, a complex four-step approach must be applied when calculating fiscal E.B.I.T.D.A. of the group and its members.

If the overall E.B.I.T.D.A. of a Belgian group is less than €10 million, group entities may collectively waive their right to determine their individual E.B.I.T.D.A. in a specific tax form (275 CRC) that is part of the C.I.T. return.<sup>84</sup> In such a case, the interest capacity depends only on the €3 million threshold.

### Interest on Debt Pushdowns Payable at Redemption

Interest must be related to the conduct of a business in order to be deductible.<sup>85</sup> That is not clearly the case when the underlying debt is incurred to

- acquire a qualifying participation in another company,<sup>86</sup> or

<sup>81</sup> These grandfathered loans remain subject to the old Belgian 5:1 thin capitalization rule, under which interest payments or attributions in excess of a 5:1 debt-equity ratio are not tax deductible.

<sup>82</sup> Article 194sexies I.T.C.; For further details, see M. Possoz and B. Buytaert, “De nieuwe EBITDA-interestaftrekbeperving,” *Tijdschrift voor Fiscaal Recht*, 2019/8, No 560, pp. 378-399.

<sup>83</sup> Article 198/1, ¶3, third limb, first dash I.T.C.

<sup>84</sup> Article 73<sup>4/11</sup>, ¶3 and 73<sup>4/12</sup>, ¶2 R.D. I.T.C.

<sup>85</sup> Article 49 I.T.C.

<sup>86</sup> Even though a participation in another company may result in a tax-exempt dividend income or capital gains only, it is generally accepted that interest incurred in connection with the financing or the acquisition of the participation is tax deductible.

- pay back equity or distribute dividends to the company's shareholders, as illustrated in the following case.

On May 8, 2018, the Court of Appeals in Antwerp handed down a remarkable ruling regarding the deduction of interest expense that at the time of a redemption is treated as a capital gain.<sup>87</sup> The facts of the case are as follows:

- On July 1, 2012, a Belgian company ("BelCo") borrowed €450 million from its Belgian parent company ("Parent"), incurring interest expense computed at an arm's length rate.
- €350 million of the amount borrowed was used by BelCo to reimburse share capital to its shareholders, including Parent, and €100 million was used to pay an interim dividend to its shareholders, also including Parent.
- The capital reduction and the interim dividend payment had been authorized by the shareholders prior to the loan agreement between BelCo and Parent.
- For tax assessment year 2013, BelCo claimed a deduction of €9,689,900 of interest expense owed to Parent.

The Belgian tax authorities challenged the deduction claiming it did not meet one of the essential requirements of Article 49 I.T.C. (see prior discussion of the general expense deduction rule), as it was not a cost or expense incurred to produce or maintain taxable income. The Court of Appeals in Antwerp sided with the Belgian tax authorities, taking the view that the reduction and payback of share capital and distribution of dividends to shareholders is not automatically a cost or expense that was incurred to produce or maintain taxable income for BelCo. After having examined the facts at hand, the Court of Appeals ruled that the interest expense was not deductible. BelCo filed an appeal against this ruling with the Court of Cassation, the highest Belgian court in tax matters.

On March 19, 2020,<sup>88</sup> the Court of Cassation ruled on the matter by following the Court of Appeals in Antwerp and establishing that the tax deductibility of an interest accrual in these circumstances is not automatically excluded, but that the company must corroborate that the interest expense was incurred or borne to obtain or maintain income. In this case, the taxpayer did not meet its burden of proof because the underlying documentation was apparently very meager and not very accurate. For example, the loan was made "for general corporate purposes."

### **Special Fact Patterns related to Interest Expenses**

#### **Patent Income Deduction and Innovation Income Deduction**

Belgium's patent income deduction ("P.I.D.") was abolished as of July 1, 2016, subject to grandfathering according to which the P.I.D. could still be applied until June 30, 2021, for qualifying patents received or applications filed before July 1, 2016.

A new innovation income deduction, or I.I.D., was introduced, based on the modified nexus approach recommended by the O.E.C.D. in B.E.P.S. Action 5. This regime was effective as of July 1, 2016.

<sup>87</sup> Court of Appeals in Antwerp, May 8, 2018, R.G. 2016/AR/2108, available at <http://www.monkey.be>.

<sup>88</sup> Cass. March 19, 2020, F.19.0025.N/1, available at [www.stradalex.com](http://www.stradalex.com).



The Act of December 19, 2023 “introducing a minimum tax for multinational companies and large domestic groups”<sup>89</sup> ensures that multinational groups or large domestic groups pay an effective 15% tax (see below). This minimum tax negates the tax benefit of the I.I.D. This is why the Act of May 12, 2024, containing various tax provisions, provides measures to safeguard the tax benefit of the I.I.D. Taxpayers can now opt to not deduct (part of) the I.I.D. but to convert it into a transferable, non-refundable tax credit, known as the I.I.D. “innovation income tax credit.”<sup>90</sup>

Under the I.I.D. regime, a corporate taxpayer can deduct from the taxable base up to 85% of its net innovation income, resulting in an effective C.I.T. that can be as low as 3.75% (i.e., 25% regular Belgian C.I.T. rate multiplied by the remaining 15% of net innovation income).<sup>91</sup> The company can therefore choose to pay more corporate tax (by converting all or part of its I.I.D. into a tax credit) to avoid a top-up tax of up to 15%. The conversion into a tax credit is done at the corporate tax rate of 25%. The tax credit can be carried forward without any time limitation to financial years in which the effective tax rate would exceed 15%.

One of the benefits of the I.I.D. over its predecessor, the P.I.D. regime, is that income from copyrighted software is also eligible for the 85% deduction.<sup>92</sup> Through June 30, 2022, the former P.I.D. regime and the new I.I.D. regime could be applied simultaneously.

### **Withholding Tax on Outbound Interest Payments**

In principle, interest paid by any Belgian company is subject to a W.H.T. of 30%.<sup>93</sup> Often, this domestic rate can be reduced by bilateral tax treaties, the E.U. Interest and Royalty Directive, and several domestic exemptions that have been implemented in Belgium. This will be the case if the Belgian company borrowed from an E.U.-affiliated company, a Belgian bank, a credit institution located in the E.E.A., or a lender resident in a tax treaty country. It applies also if the Belgian company issued registered bonds to nonresident taxpayers. In some cases, certificates must be filed alongside the W.H.T. return.

## **CAPITAL DUTY**

Pursuant to the Law of June 23, 2005, the rate of capital tax is set at 0%<sup>94</sup> for all contributions to share capital occurring on or after January 1, 2006.

The contribution in kind of Belgian situs real estate may be subject to the real estate transfer tax (10% in Flanders; 12.5% in Brussels and Wallonia) to the extent the contribution is not made exclusively or entirely in return for shares of stock. A classic



<sup>89</sup> Published in the Belgian Official Gazette on December 28, 2023.

<sup>90</sup> Articles 205/1, 289decies and 292ter I.T.C.

<sup>91</sup> If, in the tax year for which the I.I.D. is claimed, insufficient taxable income is left to absorb the full amount of the I.I.D., any unused portion can be carried forward to subsequent tax years, with no time limit (Article 205/1, ¶1, second limb I.T.C.).

<sup>92</sup> For further details, see W. Heyvaert, “Belgium’s New Innovation Income Deduction Regime,” *European Taxation*, 2018, Vol. 58, Issue 5, pp. 206-209.

<sup>93</sup> Article 261, 1° I.T.C. and Article 269, ¶1, 1° I.T.C.

<sup>94</sup> Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

example is the contribution of real estate together with an existing mortgage loan that predates the contribution.

## V.A.T.

On the basis of E.C.J. case law, a distinction is made between active and passive holding companies for purposes of V.A.T.<sup>95</sup> A passive holding company has no economic activity that gives entitlement to claim a credit for 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. In comparison, an active holding company is involved in its subsidiaries' management in return for remuneration. 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.

Based on a response in 2010 of the Belgian Minister of Finance to a Parliamentary Question,<sup>96</sup> even V.A.T. incurred in connection with a sale of shares may be creditable and refundable, under appropriate circumstances. This insight is derived from the E.C.J.'s ruling *Skatteverket v. A.B. S.K.F.*<sup>97</sup> First, one should determine whether there is in principle a direct relationship between a previous transaction, such as an input transaction on which input V.A.T. is chargeable, and a subsequent transaction, such as an output transaction that is subject to output V.A.T. If a relationship exists, the input V.A.T. can be credited by the holding company in computing its V.A.T. payments to the Belgian government. However, 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.'s ruling in *B.L.P. Group*.<sup>98</sup> Nonetheless, the input V.A.T. may still be creditable when the cost for the input services 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 to its affiliate. In essence, the parent can create its own connection by acts it takes and records it keeps.

This principle, too, was formulated in the *Skatteverket v. A.B. S.K.F.* case and 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. However, V.A.T. credit is not available if the cost of the input transaction on which V.A.T. was charged is included in the sale price of the shares, which is either exempt or out of the scope of V.A.T. On May 3, 2018, the Advocate General of the E.C.J. clarified that V.A.T. incurred in connection with a failed sale of shares is fully deductible in the above-mentioned circumstances.<sup>99</sup>

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<sup>95</sup> See e.g. E.C.J., *E.D.M. v Fazenda Pública*, April 29, 2004, Case C-29/08, available at <http://www.curia.europa.eu>.

<sup>96</sup> Parl. Question, No. 299 of January 12, 2010, Brotcorne, Q&A, Chamber 2009-2010, No. 52-102, 107.

<sup>97</sup> E.C.J., *Skatteverket v. A.B. S.K.F.*, October 29, 2009, Case C-29/08, available at <http://www.curia.europa.eu>.

<sup>98</sup> E.C.J., *B.L.P. Group P.L.C. v. Commissioners of Customs & Excise*, April 6, 1995, Case C-4/94, available at <http://www.curia.europa.eu>.

<sup>99</sup> Opinion of Advocate General Kokott in E.C.J., *Ryanair L.T.D. v. The Revenue Commissioners*, October 17, 2018, Case C-249/17, available at [www.curia.europa.eu](http://www.curia.europa.eu).

## PRIVATE P.R.I.C.A.F./P.R.I.V.A.K

Private P.R.I.C.A.F./P.R.I.V.A.K.'s are unlisted collective investment undertakings aimed at investing in unlisted companies. As such, a Private P.R.I.C.A.F./P.R.I.V.A.K. is not a holding company.

A Private P.R.I.C.A.F./P.R.I.V.A.K. can take the form of a company limited by shares ("S.A./N.V." or "S.R.L./B.V."). It is a closed-end fund, established by private investors, *i.e.*, persons investing at least €25,000 each.<sup>100</sup> The Private P.R.I.C.A.F./P.R.I.V.A.K. must have at least six private investors."

A Private P.R.I.C.A.F./P.R.I.V.A.K. exists for a period of 12 years. This period can be extended by the investors twice, each time for a period of three years. The extensions must be approved by 90% of the votes cast, representing at least 50% of the share capital.

Private P.R.I.C.A.F./P.R.I.V.A.K.'s may invest in a broad range of financial instruments issued by unlisted companies. This includes (i) shares, bonds, and debt instruments of all kinds; (ii) securities issued by other undertakings for collective investment; and (iii) derivative financial instruments such as subscription rights and options. Other investments are either partially or temporarily authorized or prohibited.

The Law of March 26, 2018, abolished a restriction that prohibited a Private P.R.I.C.A.F./P.R.I.V.A.K. from acquiring a controlling stake in a portfolio company.

Private P.R.I.C.A.F./P.R.I.V.A.K.'s must register with the Belgian tax authorities. Furthermore, the Royal Decree of May 8, 2018, provides Private P.R.I.C.A.F./P.R.I.V.A.K.'s with the ability to create compartments or silos.

A Private P.R.I.C.A.F./P.R.I.V.A.K. is subject to C.I.T., but its tax base deviates from the normal C.I.T. regime and is limited to certain elements such as non-arm's length benefits received, nondeductible expenses, and payments in lieu of dividends in stock-lending transactions. Private P.R.I.C.A.F./P.R.I.V.A.K.'s do not pay other income taxes.

The Law of March 26, 2018, granted private investors in a Private P.R.I.C.A.F./P.R.I.V.A.K. a tax reduction of 25% of capital losses realized on the shares of a Private P.R.I.C.A.F./P.R.I.V.A.K. established after January 1, 2018. The loss will be equal to the excess of (i) the capital invested by the private investors over (ii) the sum of the distributions made by the Private P.R.I.C.A.F./P.R.I.V.A.K. to the private investors as a result of the company's complete liquidation, plus the dividends paid to the private investors. The tax reduction is capped at €25,000 without indexation.

Dividends distributed by a Private P.R.I.C.A.F./P.R.I.V.A.K. are in principle subject to a 30% W.H.T. Several exceptions exist:

- Distributions paid from capital gains realized on shares held by a Private P.R.I.C.A.F./P.R.I.V.A.K. are exempt from W.H.T. As of January 1, 2018, the general participation exemption for capital gains on shares applies only if a corporate taxpayer holds a stake of at least 10% in the capital of the

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<sup>100</sup> Note that the Royal Decree of May 8, 2018, decreased the minimum investment threshold from €100,000 to €25,000.

underlying company or the underlying investment has an acquisition value of at least €2.5 million. This requirement, as well as the one-year holding requirement, do not apply to participations held by an investment company, such as a Private P.R.I.C.A.F./P.R.I.V.A.K.

- Share redemptions and liquidation gains are also exempt from W.H.T.
- The Law of March 26, 2018, extended the application of a reduced dividend W.H.T. rate of 15% or 20% (the V.V.P.R.bis regime) to indirect investments, such as those held through a Private P.R.I.C.A.F./P.R.I.V.A.K.

## STATE AID INVESTIGATION<sup>101</sup> - BELGIAN EXCESS PROFIT RULINGS

In principle, taxation of Belgian companies is based on the total amount of book profits recorded on the company's books, including certain "disallowed expenses" as well as any distributed profits in the form of dividends.

However, the Belgian "Excess Profit Rulings" ("E.P.R.") regime allowed for special treatment of selected companies that are part of a multinational group.<sup>102</sup> This was based on the premise that the Belgian subsidiary or branch of the multinational group makes a profit that could not be made by a hypothetical stand-alone company. This excess profit results from being part of a multinational group that brings along benefits such as synergies, economies of scale, reputation, and client and supplier networks. This excess profit was deductible from the Belgian entity's tax base, subject to the issuance of a favorable advance tax ruling by the Belgian Ruling Committee.

Between 2005 and 2014, Belgium applied the E.P.R. regime to approximately 55 entities. Most of them were allowed to claim a 50% to 90% deduction, without any indication that the deducted amounts were being included in a tax base elsewhere.

Surprisingly, Belgium neither notified the Commission of these rulings nor waited for the Commission's green light under the so-called "standstill obligation" before putting into effect the E.P.R. regime.

Nonetheless, due to the intensive publicity campaign under the catch phrase "Only in Belgium," the regime eventually drew the Commission's attention, triggering a preliminary investigation in December 2013 and a formal in-depth investigation in February 2015.

In January 2016, the Commission reached an adverse decision, concluding that the E.P.R. regime constituted an aid scheme within the meaning of Article 1(d) of Council Regulation (E.U.) 2015/1589. The Commission was of the view that by discounting excess profit from a beneficiary's tax base, Belgian tax authorities selectively misapplied the I.T.C. and endorsed unilateral downward adjustments of the beneficiaries' tax base although the legal conditions were not fulfilled.

The Commission also argued that the Belgian practice of issuing E.P.R.'s in favor of certain companies may have discriminated against certain other Belgian companies,

<sup>101</sup> For further details about State Aid, see Chapter V, A.

<sup>102</sup> Former Article 185, ¶2, b) I.T.C.

*"Between 2005 and 2014, Belgium applied the E.P.R. regime to approximately 55 entities."*

which did not or could not receive a ruling. The Commission found that Belgian E.P.R.'s gave a selective advantage to specific multinational companies, allowing them to pay substantially less than the regular amount of Belgian C.I.T. they would owe without an E.P.R. being in place.

The Commission issued a recovery order under which Belgium was required to take all necessary measures to recover the purported aid from all beneficiaries during the relevant ten-year period. The total amount to be recovered exceeded €900 million.

Following the Commission's negative decision and recovery order, Belgium and Magnetrol International, one of the beneficiaries of purported aid, lodged an action before the General Court of the European Union ("E.G.C.").

In February 2019, the E.G.C. annulled the Commission's decision. The court found that the Commission failed to establish the existence of an aid scheme but did not conclude on whether the E.P.R.'s gave rise to unlawful State Aid.

In April 2019, the Commission lodged an appeal to the E.C.J. to seek clarity on the standards for establishing a State Aid scheme.

In September 2019, the Commission also announced the opening of separate in-depth investigation procedures in which E.P.R.'s are labeled as individual aid.

In December 2020, Advocate General ("A.G.") Kokott issued a favorable opinion regarding the appeal lodged by the Commission against the E.G.C.'s judgment of 14 February 2019. According to the A.G., the Commission rightfully earmarked the Belgian practice of making downward adjustments to profits of Belgian corporate taxpayers forming part of a multinational group as an unlawful State Aid scheme. The opinion recommended that the E.C.J. set aside the judgment of the E.G.C. and refer the case back to the E.G.C. for a second review.<sup>103</sup>

In September 2021, the E.C.J. followed the A.G.'s opinion and overruled the E.G.C.'s Ruling. The E.C.J. ruled that the three conditions for an aid scheme to exist were met. However, the E.C.J. only looked into the methodological aspects of the E.G.C.'s judgment and referred the case back to the E.G.C., which was instructed to decide on open questions such as the existence of a selective advantage and the identification of the beneficiaries of the alleged aid.

On September 20, 2023, the E.G.C. ruled that Belgium's E.P.R. regime constitutes unlawful State Aid. In so doing, the E.G.C. confirmed the Commission's 2016 decision and rejected all arguments put forward by the Belgian state. According to the E.G.C., the Commission rightly found that the E.P.R. regime constituted financing through state resources by not taxing the excess profit, which in principle did form part of taxable profits in Belgium, resulting in a loss of tax revenue belonging to the state.<sup>104</sup> The E.G.C. also confirmed that the application of a downward profit adjustment "requires a correlation between the profit adjusted downwards in Belgium and

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<sup>103</sup> For further details, see W. Heyvaert and V. Sheikh Mohammad, "[Turning Point in the Belgian Excess Profit Rulings Appeal Procedure - Advocate General Kokott Backs the European Commission's Aid-Scheme Theory](#)," *AKD Newsflash*, December 18, 2020.

<sup>104</sup> E.G.C., September 20, 2023, Case T-131/16 RENV, available online on CURIA - Documents ([europa.eu](http://europa.eu)), paragraphs 26-32 (the "E.G.C. Ruling").



profit included in another group company established in another State.”<sup>105</sup> Because the E.P.R.’s are unilaterally issued, they are not part of the reference system (meaning the ordinary or “normal” tax system applicable).<sup>106</sup> The E.G.C. also found that the E.P.R. regime conferred a selective economic advantage on the beneficiary as it led to a relief from tax that would otherwise have been due under the Belgian corporate tax rules that distinguishes between economic operators in a comparable factual and legal situation.<sup>107</sup> In addition, the Court confirmed that the E.P.R. regime was selective because (i) it could only be used by entities that were part of a multinational group of companies,<sup>108</sup> (ii) it could not be used by companies that had decided not to make investments, centralize activities, and create jobs in Belgium,<sup>109</sup> and (iii) it could not be taken advantage of by companies belonging to a “small group.”<sup>110</sup>

## B.E.P.S. AND F.A.T.C.A.

### In General

In reaction to the O.E.C.D. initiative to combat base erosion and profit shifting (the “B.E.P.S. Project”), Belgium has implemented the following actions:

- Action Item 5 regarding the adoption of the I.I.D. using the modified nexus approach in lieu of the P.I.D.
- Action Item 2 regarding hybrid mismatches
- Action Item 3 regarding C.F.C. rules
- Action Item 4 regarding the interest limitation rule
- Action Items 8 through 10 and 13 regarding transfer pricing

Most measures were implemented in Belgium by December 31, 2018.

In 2021, the O.E.C.D. achieved a significant milestone by reaching an agreement on international tax reform to address B.E.P.S. One of the key measures included in this agreement focused on establishing a minimum tax rate of 15% for major multinational corporations, known as the “Pillar Two” initiative. Building upon this global framework, the E.U. took action by publishing European Council Directive (E.U.) 2022/2523 on December 14, 2022. This directive closely aligns with the regulations outlined by the O.E.C.D. E.U. Member States were expected to implement this directive by December 31, 2023 at the latest.

Belgium met this expectation by implementing the Act of December 19, 2023 introducing a minimum tax for multinational companies and large domestic groups (published in the Belgian Official Gazette on December 28, 2023).

<sup>105</sup> *Id.*, see paragraph 74 of the E.G.C. Ruling.

<sup>106</sup> Article 185, §1, ¶2 I.T.C.; see also paragraphs 114-117 of the E.G.C. Ruling.

<sup>107</sup> See paragraphs 107-113 of the E.G.C. Ruling.

<sup>108</sup> Article 198, §1, 10<sup>o</sup>/4 I.T.C.; see also paragraphs 119-124 of the E.G.C. Ruling.

<sup>109</sup> See paragraphs 125-132 of the E.G.C. Ruling.

<sup>110</sup> See paragraphs 133-140 of the E.G.C. Ruling: indeed, the Commission’s “sample” had shown that “none of those rulings concerned entities belonging to small groups of undertakings.”

## **B.E.P.S. Action 2: Hybrid Mismatches**

The Belgian government has implemented the E.U. anti-hybrid mismatch rule provided for in the A.T.A.D.<sup>111</sup> Dividends derived from a subsidiary are excluded from the D.R.D. to the extent that the subsidiary has deducted, or can deduct, this income from its profit.

### **Definitions**

Definitions of hybrid mismatch, hybrid entity, and hybrid transfer were introduced into Belgian tax law:<sup>112</sup>

- A hybrid mismatch is an arrangement resulting in either of two tax benefits. The first is a deduction of expenses for both a Belgian company or permanent establishment and a foreign enterprise or establishment thereof resulting in a double deduction. The second is a deduction for one of the participants to the arrangement without an income inclusion by the other participant resulting in a deduction without inclusion in income.
- A hybrid mismatch requires associated enterprises that are part of the same group or that act under a structured arrangement. No hybrid mismatch exists where the non-inclusion is due to the application of a tax regime that derogates from the standard tax law or differences in the value attributed to a payment, including differences resulting from the application of transfer pricing rules.
- A hybrid entity is any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction but is treated as a transparent entity under the tax laws of another jurisdiction.

A “hybrid transfer” is any arrangement to transfer a financial instrument that is treated for tax purposes as having been derived simultaneously by more than one of the parties to the arrangement.

### **Taxable Hybrids**

#### **Disregarded Permanent Establishment Mismatch Rule**<sup>113</sup>

Belgian companies will be taxed on profits attributable to a permanent establishment in another E.U. Member State that was exempt in that Member State under a tax treaty. Note that the profits must be realized due to a hybrid mismatch arrangement and not taxed in the jurisdiction where the permanent establishment is located.

#### **Reverse Hybrid Entity Mismatch Rule**<sup>114</sup>

Belgium will consider a hybrid entity incorporated or established in Belgium to be taxable if one or more associated nonresident entities are established in one or more jurisdictions that consider the Belgian entity to be taxable.

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<sup>111</sup> Articles 185, 198, and 203 I.T.C.

<sup>112</sup> See Article 2, ¶1, 16° I.T.C.

<sup>113</sup> Article 185, §1, ¶2 I.T.C.

<sup>114</sup> Article 185, §1, ¶3 I.T.C.

*“The Belgian government has implemented the E.U. anti-hybrid mismatch rule provided for in the A.T.A.D.”*

The hybrid entity's income will be taxed in Belgium to the extent that it is not already taxed under the laws of Belgium or any other jurisdiction. This rule does not apply to collective investment vehicles.

#### Financial Instrument Mismatch<sup>115</sup>

A taxable hybrid mismatch may occur due to different characterizations of the same financial instrument or item of income resulting in a deduction for the foreign enterprise or its establishment and no inclusion for the Belgian company or establishment of the deemed beneficiary under the laws of the other jurisdiction.

#### Hybrid Entity Mismatch<sup>116</sup>

A hybrid mismatch exists where deductible income is paid by a foreign hybrid entity or its establishment in another country without a taxable inclusion for the Belgian company. This is the case when a foreign hybrid entity is considered transparent for Belgian purposes and as a taxable entity in the foreign jurisdiction.

#### Nondeductible Hybrids

The deduction of expenses in Belgium in the context of hybrid mismatches will be disallowed.

#### Double Deduction Rule<sup>117</sup>

Payments will be disallowed if there is a double deduction, for both a Belgian company or permanent establishment and a foreign enterprise or permanent establishment, from non-dual inclusion income.

#### Deduction Without Inclusion Rules<sup>118</sup>

The deduction of hybrid mismatch payments is prohibited in six instances where a payment is deductible in Belgium without a corresponding foreign inclusion:

- **Financial instrument mismatches.** A payment is made under a financial instrument where (i) the deduction without inclusion would be due to a difference in characterization of the instrument or income and (ii) the payment is not included in the taxable income of the beneficiary within a reasonable period of time.
- **Reverse hybrid entity mismatches.** A payment is made to a reverse hybrid entity, *i.e.*, an entity that is considered a taxpayer under Belgian law and as a transparent entity under the laws of another jurisdiction.
- **Hybrid allocation mismatches.** A payment is made to an entity with one or more establishments, where the non-inclusion abroad is the result of differences in the allocation of payments made to the hybrid entity's head office and its establishment, or between two or more establishments of that same entity.

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<sup>115</sup> Article 185, §2/1, a) I.T.C.

<sup>116</sup> Article 185, §2/1, b) I.T.C.

<sup>117</sup> Article 198, §1,10°/1 I.T.C.

<sup>118</sup> Article 198, §1,10°/2 I.T.C.



- **Hybrid permanent establishment mismatches.** A payment is made to an entity that is regarded as a permanent establishment under the laws of its head office but disregarded under the law of the establishment's jurisdiction and the corresponding income is not taxable under the laws of the head office's jurisdiction.
- **Hybrid entity mismatches.** A payment is claimed as a deduction without being included in the beneficiary's taxable income, such as if a Belgian entity is treated as taxable in Belgium but as transparent in the recipient's jurisdiction.
- **Deemed permanent establishment payment mismatches.** A deemed payment is made between a head office and its permanent establishment, or between two or more permanent establishments, that has already been deducted from non-dual inclusion income.

#### Imported Hybrid Mismatches<sup>119</sup>

Imported hybrid mismatches occur between interested parties in foreign jurisdictions who shift the tax consequences to Belgium. For example, a Belgian entity contracts an ordinary loan with a foreign entity that itself has concluded a hybrid loan with another foreign entity.

#### Tax Residency Mismatch Rule

<sup>120</sup>Payments are not deductible if they are made by a Belgian domestic company that is also a tax resident in one or more other jurisdictions and they are deductible from income in one of the other jurisdictions against income that is not taxable in that other jurisdiction. A deduction is allowed, however, if the other jurisdiction is an E.U. Member State with which Belgium has concluded a tax treaty that determines the company is treated as a Belgian-resident taxpayer.

Most of the above rules are applicable from 2020 (book years ending December 31, 2019).

#### **B.E.P.S. Action 3: C.F.C. Rules**

Until January 1, 2019, Belgium did not have C.F.C. legislation in place *per se*, but it had, and still has, extensive anti-abuse rules with an effect similar to C.F.C. rules. For example, Article 344 §2 of the I.T.C. tackles transfers of assets to entities that are resident in 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 on taxpayers making payments to offshore entities.

Belgian law contains a look-through tax, sometimes referred to as "Cayman tax" for income derived by individual taxpayers from the use of foreign vehicles such as trusts or foundations. Since 2014, these juridical arrangements must be reported on the individual's personal income tax return, and in many instances the trust or foundation will be considered tax transparent so that the income will be taxable directly in the hands of the resident individual who is the beneficiary.

<sup>119</sup> Article 198, §1,10°/3 I.T.C.

<sup>120</sup> Article 198, §1,10°/4 I.T.C.

In addition, the A.T.A.D. contains a C.F.C. component, which is intended to deter profit shifting to low-tax or no-tax jurisdictions. These C.F.C. rules are mandatory in all E.U. Member States. The Commission aims to discourage income shifting by re-attribution of income from a passive, lightly taxed C.F.C. to its E.U. parent company.

Belgium has opted to implement C.F.C. rules that target income only when derived by a C.F.C. through non-genuine arrangements set up for the essential purpose of obtaining a tax advantage.<sup>121</sup> These rules became effective as of January 1, 2019.

On December 22, 2023,<sup>122</sup> the Belgian C.F.C. rules were reformed drastically. This reform shifts the Belgian C.F.C. regime from A.T.A.D. Model B (the transactional approach) to A.T.A.D. Model A (the entity approach). This means that the passive income of a C.F.C. that is directly owned by a Belgian controlling company (see the participation requirement below) and that is subject to low taxation abroad (see the taxation requirement below) will be added to the Belgian tax base of the controlling company, unless the C.F.C. can demonstrate sufficient economic substance.

The participation requirement is met if the taxpayer alone, or together with its associated entities, holds a qualifying participation in a foreign company. The participation threshold is more than 50% of the voting rights in the foreign company, or at least a 50% participation in its capital or profit entitlement.

The tax authorities published an explanatory note for corporate income tax returns for tax year 2024 with the following guidance:

- The taxpayer needs to hold (directly) at least one share<sup>123</sup> in the potential C.F.C.
- A purely indirect holding or a holding only through associated entities does not constitute a C.F.C.
- If the taxpayer holds at least one share, the direct participation of the taxpayer must be aggregated with the direct participation held by any associated entity (not on a *pro rata* basis) to assess if any of the participation thresholds are met by the taxpayer.

For example: Belgian Company A has a direct participation of 10% in foreign Company B and 40% in Company C. The latter has a direct participation of 42% in B. Since A and C are associated entities, the full participation for application of the C.F.C. regime is 52%.<sup>124</sup>

This implies that the notion of control under the new Belgian C.F.C. legislation (and A.T.A.D.) differs from its definition under the B.C.C.A. Taxpayers need to ensure that they pay proper attention to these differences when reviewing group entities that potentially qualify as C.F.C.'s, as they may lead to group entities that are not

<sup>121</sup> Article 185/2, ¶1 I.T.C.

<sup>122</sup> Program Law, published in Belgian Official Gazette on December 29, 2023.

<sup>123</sup> Meaning a voting right, participation in capital, or profit entitlement right.

<sup>124</sup> This is calculated as follows:  $10\% + 42\% = 52\%$ . In other words, there is no proportional calculation of the associate's participation, as this would result in a full participation for application of the C.F.C. regime calculated as  $10\% + (42\% \times 40\%) = 26.80\%$ .



controlled by their parent companies under the B.C.C.A. unexpectedly qualifying as C.F.C.'s for tax purposes.

The taxation requirement is met when the C.F.C. is deemed to be low taxed, *i.e.*, if (i) it is not subject to any income tax or (ii) is subject to income tax at a rate that is less than 50% of the rate that would be imposed were it a resident of Belgium.<sup>125</sup> The C.F.C. will be presumed to be low taxed when it is established in a jurisdiction listed as a tax haven by the E.U. or Belgium (see above), although this presumption is rebuttable.

The new C.F.C. legislation introduces three safe harbors at the level of the Belgian controlling company. The C.F.C. income inclusion should not be applied under the following circumstances:

- The Belgian controlling company shows that the C.F.C. carries out a substantial economic activity supported by personnel, equipment, assets, and buildings defined as “the offering of goods or services on a particular market,” excluding intercompany services, unless the respective transactions are carried out at arm’s length.
- Less than one third of the total income of the C.F.C. originates from so-called “passive income.”
- The C.F.C. is a regulated financial institution to which the E.B.I.T.D.A. interest deduction limitation does not apply, and for which one third or less of the total income is derived from transactions with the Belgian controlling company or entities associated with the latter.

To determine the portion of the C.F.C.’s income that must be included in the taxable basis of the Belgian controlling company, the profit of the C.F.C. must be based on Belgian accounting and tax rules as if the C.F.C. were located in Belgium. The income to be included is then limited to (i) the part of income that is not distributed and (ii) the C.F.C.’s passive income. Passive income is broadly defined and includes, not only income from interest, royalties, dividends, and from the disposal of shares, but also income from rental and leasing property, certain financial activities, and income from the purchase and sale of goods and services which add little or no economic value to the C.F.C. This income is allocated in proportion to the Belgian company’s direct voting rights, direct ownership rights in the share capital, or rights to the profits of the C.F.C. (whichever is higher).

#### **B.E.P.S. Action 4: Excessive Interest Deductions**

Similar to most other countries, Belgium already had various rules limiting excessive interest deductions. The most well-known rule is the 5:1 thin capitalization rule, under which interest payments or attributions in excess of a 5:1 debt-equity ratio are not tax deductible. Belgium has implemented the A.T.A.D. by providing an interest limitation rule to discourage companies from creating artificial debt arrangements designed to minimize tax. This rule entered into effect on January 1, 2019, and is effective for tax assessment year 2020 and later. Interest is deductible only up to a certain amount, *viz.*, the greater of 30% of an entity’s tax-adjusted earnings before

<sup>125</sup> *Id.*, ¶2.

*“The new C.F.C. legislation introduces three safe harbors at the level of the Belgian controlling company.”*

interest, taxes, depreciation, and amortization (essentially E.B.I.T.D.A.) or €3 million. This was accomplished by enactment of the Law of December 25, 2017, which transposed A.T.A.D. into national law.<sup>126</sup>

Loans entered into prior to June 17, 2016, are grandfathered. Consequently, interest on such loans will not be subject to the limitation based on 30% of E.B.I.T.D.A., provided that no substantial changes are made to these loans on or after June 17, 2016. According to the Minister of Finance, substantial changes are, *inter alia*, changes in the duration of the loan, the interest rate due under the loan, or a party to the loan. Additionally, financial institutions are carved out of the interest limitation rule altogether.<sup>127</sup>

For purposes of the interest limitation rule, certain items are earmarked as equivalent to interest and, thus, captured by the rule. A Royal Decree dated December 27, 2019, provides a description of income and expenses that are economically equivalent to interest. Included are payments under profit participating loans, capitalized interest, foreign exchange gains/losses related to interest payments, guarantee provisions, and original issue discount on interest-free or abnormally low-interest loans. Taxpayers seeking certainty can request a ruling as to specific costs and products.

### **B.E.P.S. Actions 8, 9, 10, and 13: Transfer Pricing**

Belgium has transfer pricing rules in place to avoid profit shifting, and in recent years transfer pricing audits have increased significantly. However, until recently, there were no specific statutory transfer pricing documentation requirements under Belgian law. It is of course advisable to have sufficient documentation available, as a lack of documentation may result in a thorough transfer pricing audit.

Belgium has enacted legislation to introduce specific transfer pricing documentation requirements based on B.E.P.S. Action 13. This means that the O.E.C.D.'s recommended three-tiered approach to transfer pricing documentation is mandatory in Belgium. As a result, a Belgian entity forming part of an international group must compile a Master File and a Local File, if certain criteria are met. In addition, if the ultimate parent of a multinational group is a Belgian company, and if it has gross consolidated revenue of at least €750 million, it must file a Country-by-Country Report with the Belgian tax authorities within 12 months from the closing of the consolidated financial statements of the group.

### **F.A.T.C.A.**

F.A.T.C.A.'s primary function is to require financial institutions outside the U.S. to report information on U.S. account holders to the I.R.S. The associated penalty for noncompliance is the “big stick” of a 30% U.S. W.H.T. on certain income and principal payments to recalcitrant financial institutions. The W.H.T. applies to payments made by all persons, even those unrelated to the U.S. account in issue.

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<sup>126</sup> Article 40 of the Law of December 25, 2017, on the C.I.T. Reform (*Belgian State Gazette*, December 29, 2017) introducing Article 198/1 I.T.C., to take effect on January 1, 2020.

<sup>127</sup> For further information on the interest limitation rule, see W. Heyvaert and E. Moonen “Belgium – ATAD Implementation in Belgium: An Analysis of the New Interest Limitation Rule,” *European Taxation*, 2019, Vol. 59, No. 7 pp. 354-360.

On April 23, 2014, Belgium concluded a Model 1 Reciprocal Agreement with the U.S., meaning that foreign financial institutions established in Belgium will be required to report information on U.S. account holders directly to the Belgian tax authorities, who in turn will report to the I.R.S.

### **Pillar Two - Minimum Tax for Multinational Companies and Large Domestic Groups**

The Law of December 19, 2023 introducing a minimum tax for multinational companies and large domestic groups states that based on the consolidated figures of the group, taxpayers need to identify the jurisdictions in which the effective tax burden is lower than 15%. The 15% minimum tax rate is then achieved through three different surcharges:

- **Qualified Domestic Top-up Tax (“Q.D.M.T.T.”):** This tax applies if all Belgian entities in the aggregate do not pay tax at an effective rate of 15%, for example, due to the application of tax incentives such as the investment deduction or the I.I.D.
- **Income Inclusion Rule (“I.I.R.”):** If foreign group entities are taxed in one or more low-tax jurisdiction, the Belgian ultimate parent entity or a Belgian intermediate parent entity will be partly taxed on that income proportional to the parent entity’s ownership interest in the qualifying income of the low-taxed group entity. If the low-tax jurisdictions impose an income top-up tax, Belgium can only apply the I.I.R. if the exchange of information shows that the low-taxed jurisdictions have not (sufficiently) taxed the income.
- **Undertaxed Profit Rule (“U.T.P.R.”):** If the tax authority in the country of a targeted parent entity does not fully apply the I.I.R., the revenue services in the other countries where the group operates can disallow tax deductions or impose withholding taxes to arrive at a minimum 15% overall corporate tax rate. Belgium has opted to levy an additional U.T.P.R. tax.

The minimum tax provided for in the Law of December 19, 2023 took effect from 2024 (for fiscal years beginning on December 31, 2023 or later), except for the U.T.P.R. surcharge, for which a grace period applies until 2025.

The computation of the various surcharges goes as follows:

- The minimum tax legislation applies to large multinational groups with consolidated sales exceeding €750 million during two out of the four previous fiscal years and to domestic groups exceeding the €750 million threshold. Group entities can be either corporations or permanent establishments. Certain entities are excluded (e.g., government agencies, international organizations, non-profit organizations, pension funds, investment funds, and real estate investment vehicles).
- The result for each jurisdiction is then determined based on the consolidated financial statements of the group for the local group entities, with certain adjustments (e.g., exemptions for dividends and capital gains, certain disallowed expenses, and transfer pricing adjustments). The result is the qualifying income or loss by jurisdiction.

- Subsequently, the effective tax levied on the local group entities in each jurisdiction is computed. Deferred taxes are also taken into account.
- The difference between the effective tax rate and the minimum tax rate (15%) results in the percentage of the top-up tax, which is then multiplied by the excess profit of the jurisdiction. Excess profit is determined by reducing the qualifying income of the jurisdiction by an exclusion based on substance (the substance based income exclusion, or “S.B.I.E.”).<sup>128</sup> If applicable, the domestic top-up tax payable abroad must be considered (see above). If a loss is recorded in a particular jurisdiction, no top-up tax is applied. There is a *de minimis* exclusion if all group entities in a jurisdiction generate revenue of less than €10 million on average and a profit of less than €1 million on average for the reporting year and the two preceding years.
- Finally, it is determined which group entities in Belgium are liable for the Q.D.M.T.T., the I.I.R. surcharge, or the U.T.P.R. surcharge.

To reduce the administrative burden for both multinational groups and tax authorities, “safe harbors” have been developed to easily determine whether there is no risk of low-taxed profit in a particular jurisdiction. Pending the final list of safe harbors, a temporary arrangement has been developed based on the data in the group’s country-by-country report.<sup>129</sup>

To determine that a jurisdiction poses no risk of low-taxed profit, three tests have been devised:

- **De Minimis Test:** The group has reported total revenues of less than €10 million and a profit (loss) before income tax of less than €1 million in that jurisdiction in its country-by-country report.
- **Effective Tax Rate (“E.T.R.”) Test:** The (i) relevant taxes in the financial reporting and (ii) the profit (loss) before income tax from the country-by-country report demonstrate that the effective tax rate exceeds 15% for reporting years starting in 2023 or 2024, 16% for reporting years starting in 2025, and 17% for reporting years starting after 2026.
- **Routine Profit Test:** The group’s profit (loss) before income tax in a jurisdiction does not exceed the amount of income excluded based on concepts of economic substance, calculated by using the abovementioned percentages of tangible assets and payroll costs.

The Minister of Finance has confirmed that a carried-forward D.R.D. is included in the “relevant taxes” that count towards achieving the effective tax rate of 15%. Deferred taxes related to a carried-forward D.R.D. are treated the same as losses carried forward for the calculation of the minimum tax. Therefore, the use of a carried-forward D.R.D. does not negatively impact the calculation of the minimum tax, as it does not risk falling below the 15% threshold and thus does not necessitate a top-up tax. The application of the minimum tax at the level of a foreign



<sup>128</sup> Specifically excluding a standard return on tangible assets amounting to 10% in 2023 (decreasing to 5% in 2033) and payroll costs amounting to 8% in 2023 (decreasing to 5% in 2033).

<sup>129</sup> Article. 321/1, 15° I.T.C.

subsidiary results in a tax burden of 15%, thus satisfying the taxation requirement of the D.R.D.<sup>130</sup> The minister noted that the D.R.D. does not apply if low-taxed income accumulated in years before the introduction of the minimum tax are distributed. This means that dividends from countries with a local top-up tax of at least 15% are generally eligible for the D.R.D., unless another exclusion applies.

Meanwhile, measures have already been introduced to safeguard the I.I.D. from the effects of the minimum tax legislation (see above). Additionally, the O.E.C.D. has introduced further “safe harbors” concerning the Q.D.M.T.T. and the U.T.P.R. Finally, there is a simplified calculation for non-substantial entities that are not included in the consolidated financial statements of the group due to their limited size or materiality, based on the data in the group’s country-by-country report.<sup>131</sup>

Multinational groups within the scope of the minimum tax must apply for an enterprise number with the Crossroads Bank for Enterprises. This requirement applies not only to Belgian groups but also to foreign groups. The enterprise number is necessary to use the online MyMinfin applications and to validly make any advanced payments on the minimum tax. If such advance payments are not made during the financial year, the amount of any minimum tax due will be increased.

In principle, groups only need to file an information form in one country. However, because it may take some time for the necessary data to reach the Belgian Revenue Service, a form must be submitted that only includes the I.I.R. and the U.T.P.R. due in Belgium. Based on this form, the Belgian Revenue Service can impose tax.

## INCOME TAX TREATIES

As of June 12, 2024, Belgium has 96 income tax treaties in effect, with the jurisdictions listed below.<sup>132</sup>

|                      |           |             |              |
|----------------------|-----------|-------------|--------------|
| Albania              | Finland   | Macedonia   | Seychelles   |
| Algeria              | France    | Malaysia    | Singapore    |
| Argentina            | Gabon     | Malta       | Slovakia     |
| Armenia              | Georgia   | Mauritius   | Slovenia     |
| Australia            | Germany   | Mexico      | South Africa |
| Austria              | Ghana     | Moldova     | South Korea  |
| Azerbaijan           | Greece    | Mongolia    | Spain        |
| Bahrain              | Hong Kong | Montenegro  | Sri Lanka    |
| Bangladesh           | Hungary   | Morocco     | Sweden       |
| Belarus              | Iceland   | Netherlands | Switzerland  |
| Bosnia & Herzegovina | India     | New Zealand | Taiwan       |
| Brazil               | Indonesia | Nigeria     | Tajikistan   |
| Bulgaria             | Ireland   | Norway      | Thailand     |
| Canada               | Israel    | Oman        | Tunisia      |

<sup>130</sup> Article 203 § 1, 1, 1° and 203 § 1, 2 I.T.C.

<sup>131</sup> See art. 321/1, 15° I.T.C.

<sup>132</sup> Belgium has negotiated or is negotiating new treaties with several other countries.

|                   |             |             |                      |
|-------------------|-------------|-------------|----------------------|
| Chile             | Italy       | Pakistan    | Turkey               |
| China             | Ivory Coast | Philippines | Turkmenistan         |
| Congo (Dem. Rep.) | Japan       | Poland      | Ukraine              |
| Croatia           | Kazakhstan  | Portugal    | United Arab Emirates |
| Cyprus            | Kosovo      | Romania     | United Kingdom       |
| Czech Republic    | Kuwait      | Russia      | United States        |
| Denmark           | Kyrgyzstan  | Rwanda      | Uruguay              |
| Ecuador           | Latvia      | San Marino  | Uzbekistan           |
| Egypt             | Lithuania   | Senegal     | Venezuela            |
| Estonia           | Luxembourg  | Serbia      | Vietnam              |

In addition, Belgium has in effect a substantial number of Tax Information and Exchange Agreements (“T.I.E.A.’s”). Nearly all of these T.I.E.A.’s are concluded with countries that do not have a comprehensive income tax treaty in force with Belgium, *i.e.*, most often tax havens.

Belgium signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“M.L.I.”), thereby incorporating the minimum standards outlined by the B.E.P.S. Project into its existing tax treaties. Belgium designated 96 of its income tax treaties as Covered Tax Agreements, *i.e.* tax treaties to be modified through the M.L.I.<sup>133</sup>

On October 1, 2019, the M.L.I. entered into force for Belgium. For an income tax treaty to be covered by the M.L.I., both signatories must have (i) joined the M.L.I., (ii) included each other in their list of covered income tax treaties, and (iii) deposited their instruments of ratification.

Belgium submitted reservations against the agency permanent establishment provision. Regarding the elimination of double taxation provided for in the M.L.I., Belgium will incorporate Option B regarding the credit method in its existing double tax treaties so long as the other contracting state is also a party to the M.L.I. and has not stated any reservations regarding this provision.

Recent significant changes include the signature of replacement income tax treaties with France on November 9, 2021,<sup>134</sup> and the Netherlands on June 21, 2023.<sup>135</sup> Other changes include the signature of a competent authority agreement with Austria on May 30, 2023, the signature of an agreement relating to the interpretation of article 5 of the income tax treaty with the Netherlands on November 23, 2023, regarding employees working from a home office, and the signature of a mutual agreement regarding Part VI (arbitration) of the M.L.I. with Switzerland on July 3, 2023.

<sup>133</sup> See the official website of the Belgian Ministry of Finance for the full list of countries: MyMinfin ([fgov.be](http://fgov.be)).

<sup>134</sup> See P.-J. Wouters, “The Belgium-France Income and Capital Tax Treaty (2021): What’s New?” *Bulletin for International Taxation*, 2022, Vol. 76, No 3, pp. 159-167.

<sup>135</sup> See W. Heyvaert, “New bilateral tax treaty Belgium and the Netherlands.” November 7, 2023.



## D.A.C.6 – MANDATORY DISCLOSURE OF AGGRESSIVE CROSS BORDER TAX STRUCTURES<sup>136</sup>

On May 25, 2018, the Council of the European Union adopted Directive (E.U.) 2018/855 (referred to as “D.A.C. 6”). This Directive introduced mandatory disclosure rules for E.U.-linked intermediaries or, under specific circumstances, for taxpayers themselves (e.g., when the intermediary is precluded from reporting by virtue of the client-attorney privilege).

“Under Belgian law, cross-border arrangements are reportable if they meet at least one of the hallmarks set out in the Law . . .”

Belgium implemented the Directive into domestic law on December 12, 2019 (*Belgian State Gazette*, December 30, 2019). Under Belgian law, cross-border arrangements are reportable if they meet at least one of the hallmarks set out in the Law (which are identical to hallmarks A-E listed in Annex IV of the Directive). Hallmarks are broad categories setting out particular characteristics identified as potentially indicative of aggressive tax planning. Most hallmarks enter into play only if they meet a so-called “main benefit test” (i.e., where a tax benefit is the main or one of the main objectives of the arrangement). Belgian law does not cover purely domestic arrangements.

Until recently, the reporting deadlines were (a) August 31, 2020, for arrangements with a first step implemented between June 25, 2018 and July 1, 2020, and (b) within 30 days for arrangements with a first step implemented effective July 1, 2020 or later. However, due to the COVID-19 crisis, Belgium extended these deadlines.

The Law of December 20, 2019 provided that fines for any failure to report in a timely, sufficient, and complete manner would range from €1,250 to €100,000. On May 10, 2023, the Supreme Administrative Court (*Raad Van State* or *Conseil d’État*) annulled the Royal Decree implementing administrative fines and provided guidance in the application of such fines. This does not mean that administrative fines can no longer be imposed. The minimum and maximum penalty rates are still regulated by the Law of December 20, 2019.

An intermediary who is precluded from reporting pursuant to a legal professional privilege (“L.P.P.”) must inform in writing any other intermediary or the relevant taxpayer of the fact that the reporting obligation shifts to them. However, the L.P.P. exemption does not apply for the reporting of marketable arrangements. The question arose whether the Belgian Constitutional Court would accept this restrictive interpretation of the L.P.P.<sup>137</sup> Several Belgian bar and attorney associations introduced annulment procedures before the Belgian Constitutional Court to request the annulment of the Law.

Noting that the notification obligation was required to satisfy the requirements of the Directive, the Belgian Constitutional Court requested a preliminary ruling from

<sup>136</sup> See W. Heyvaert and V. Sheikh Mohammad, “European Union’s New Reporting Obligations for Tax Intermediaries: Key Features of the Belgian Administrative Guidance – D.A.C.6,” *Insights*, Vol. 8, No 2 (2021), pp. 3-10.

<sup>137</sup> See W. Heyvaert and V. Sheikh Mohammad, “*Secret professionnel de l’avocat et D.A.C. 6 - une conciliation (im)possible ?*” *Journal de droit fiscal*, 2019, No 11, pp. 321-329; L. Vanheeswijck, “D.A.C. 6: het einde van het beroepsgeheim in fiscale zaken?” *Tijdschrift voor fiscaal recht*, 2019, n° 560, p. 377.

the E.C.J.<sup>138</sup> The request for a preliminary ruling concerned the compatibility of the Directive with Article 7 (right to respect for private life) and Article 47 (right to a fair trial) of the Charter of Fundamental Rights of the E.U. insofar as it requires legal counsel to notify other intermediaries of a need to report under D.A.C.6.

On December 8, 2022, the E.C.J. confirmed in *Orde van Vlaamse Balies and Others v. Vlaamse Regering* (Case C-694/20) that the obligation for lawyer intermediaries advising on potentially aggressive cross-border tax arrangements to notify other nonclient intermediaries of their reporting obligations vis-à-vis the tax authorities infringes on the right of taxpayers to have the privacy of their communications with legal counsel respected. With this landmark judgment, the E.C.J. confirmed that the L.P.P. protects the confidentiality of lawyer-client communications not only in relation to the exercise of the client's rights of defense, but also for legal advice beyond the context of litigation. On July 20, 2023, the Belgian Constitutional Court annulled the Flemish regulations transposing D.A.C.6 in this regard (Case No. 111/2022) and similar cases are now pending before the Belgian Constitutional Court for the other transposing measures.<sup>139</sup>

## A.T.A.D. 3 – UNSHELL DIRECTIVE

One of the latest tax developments in the E.U. is the proposal for a Council Directive laying down rules to prevent misuse of shell entities for tax purposes. Introduced by the European Commission in December 2021, the Directive is commonly referred to as A.T.A.D. 3 or the Unshell Directive.

In the Explanatory Memorandum of the draft proposal, the Commission explains the purpose of the Directive:

While important progress has been made in [the area of ensuring fair and effective taxation] in the last years, especially with the adoption of the Anti-Tax Avoidance Directive (A.T.A.D.) and the expansion of scope of the Directive on Administrative Cooperation (D.A.C.), legal entities with no minimal substance and economic activity continue to pose a risk of being used for improper tax purposes, such as tax evasion and avoidance, as confirmed by recent massive media revelations.

In fact, within the E.U., legal personality is granted by Member States based on purely formal requirements such as minimum capital or minimum number of shareholders, without any review of or checks on the economic activity of the entity.

Therefore, it is relatively easy for non-E.U. investors to interpose an E.U. entity to enjoy advantageous tax treatment under D.T.T.'s, E.U. primary law such as the

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<sup>138</sup> E.C.J., *Orde van Vlaamse Balies and Others v. Vlaamse Regering*, Case C-694/20, December 21, 2021, available at [www.curia.europa.eu](http://www.curia.europa.eu).

<sup>139</sup> The Belgian Constitutional Court issued an interlocutory judgment on the Federal transposing measures (Case No. 103/2022). There are cases pending regarding the Walloon transposing decree (joint case numbers 7480, 7498 and 7537), the transposing decree of the French-speaking community (case numbers 7535, 7581, and 7585) and the transposing ordinance of the Brussels-Capital Region (case numbers 7481, 7510, 7511, and 7521).

fundamental freedoms or secondary law such as the P.S.D. and the I.R.D., and national laws of Member States.

To combat the inappropriate use of shell companies, the draft proposal outlines rules to identify shell entities in the E.U., to allow for the exchange of information among Member States about identified shell entities, and to deny E.U. tax benefits to identified shell entities. Purportedly, the goal is not to make shell entities disappear, but to avoid their abusive use for tax purposes.

If adopted and implemented, undertakings deemed as lacking minimal substance would be denied treaty benefits and benefits under E.U. primary and secondary law, particularly under the P.S.D. and I.R.D.

### **First Step: Is the Entity in Scope?**

All E.U. entities are in scope except entities with listed securities, such as publicly traded stocks or bonds and regulated entities. In the initial proposal by the Commission, entities with at least five full-time employees are also out of scope. However, this exclusion was removed by the European Parliament.

In contrast with the O.E.C.D.'s Pillar One and Pillar Two initiatives, the A.T.A.D. 3/ Unshell Directive is not limited to large M.N.E.'s.

### **Second Step: Is the Entity at Risk?**

The proposed Directive describes elements that identify undertakings that may lack substance and are at risk of potential misuse for tax purposes. It initially specifies the criteria that would lead to the obligation for taxpayers to report their substance on their tax returns. To be "at risk," an entity must meet three criteria:

- More than 65% of its income or assets are categorized as passive
- More than 55% of its activities or assets relate to cross-border transactions
- Administration and management are outsourced to a third-party

If an entity is at risk, it must report the following on its annual tax return:

- Whether premises are available for its exclusive use (shared use by entities of the same group also counts)
- Whether it has at least one active E.U. bank account
- Whether at least one qualified director or the majority of the full-time employees live close to the undertaking and are involved in the decision-making process

The current proposal suggests that Member States impose a penalty of at least 2% of the entity's turnover for incorrect reporting or failure to report. In the event of a false declaration, an additional penalty of at least 4% of the entity's revenue would be imposed.

National tax authorities must assess each year whether an entity or undertaking is a shell based on the information furnished by the company. A presumed shell entity can present proof to show it has genuine economic activity and sufficient nexus with the Member State of which it claims to be a tax resident. Even if an entity is not a

shell under the A.T.A.D. 3/Unshell Directive, it may still be considered a shell under national law.

### **Third Step: What if the Entity is a Shell?**

Shell entities are not eligible for tax benefits under the network of D.T.T.'s in force and effect of the Member State in which tax residence is claimed. Also, it is not considered to be resident in that Member State for purposes of claiming benefits of certain European Directives, such as the P.S.D. and the I.R.D.



# SWEDEN

## Author

Erik Nilsson  
Svalner Skatt & Transaktion  
Stockholm, Sweden

## 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, modifications in recent years, e.g., intragroup interest restrictions, have affected this status adversely, although perhaps no more adversely than other countries that have implemented O.E.C.D (B.E.P.S.) and E.U. measures on tax avoidance. The key features of the Swedish holding company regime include the following:

- 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 (approximately 90 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains
- A low corporation income tax rate (*i.e.*, 20.6%)
- Relatively low requirements on minimum share capital – SEK 25,000 (approx. €2,200)
- 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.

## PARTICIPATION EXEMPTION

### **General**

The net income of a Swedish company is normally subject to corporation income tax at a rate of 20.6%. However, if both the holding company and the subsidiary are qualifying entities under the participation exemption, income from capital gains

The author acknowledges the contribution of his colleague Arvid Rheborg in the preparation of this chapter.

and dividends are tax exempt. Under 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 chapter 7 I.T.A.
- A Swedish savings bank
- A Swedish mutual insurance company
- A foreign company resident within the E.E.A. that is the equivalent of any of the foregoing entities

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, provided such taxation is similar to the taxation of a Swedish A.B. In general, a tax charge of at least 10% should be acceptable. 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. This is discussed below at **Qualifying Foreign Entities**. The share must also be a capital asset, generally defined as assets other than trading stock, inventory, work-in-progress, receivables and similar assets, equipment, patents, and other intangibles. Additionally, the share must meet at least one 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.
- 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.

The foregoing is subject to an exception, generally provided for in the B.E.P.S. Action Plan and E.U. directives combating tax abuse. Dividends received from foreign companies are taxable in Sweden if the dividend may be deducted by the payor, such as in the case of an interest expense payment or some similar expense.

## **Capital Gains**

Capital gains on the disposal of business-related shares are tax exempt. Accordingly, capital losses derived from the disposal of those shares are not tax deductible. If the shares are listed, the capital gains are tax exempt provided that the shares have been deemed business-related 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**

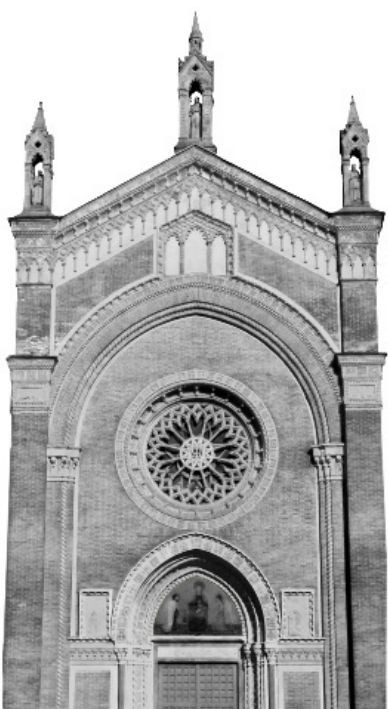
Shares in foreign legal entities may also qualify as business-related shares if the legal entity corresponds to a Swedish limited liability company. The relevant provisions in the I.T.A. do not state what conditions should be met in order for a foreign legal entity to correspond to a Swedish A.B. In 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 a Russian 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. In another case regarding a Lichtenstein Anstalt, the Supreme Administrative Court held that the circumstance that income may be tax-free in the company’s state of residence does not affect the determination of whether the company is fully taxable. The Supreme Administrative Court stated that only if the company is subject to a general and complete exemption from income taxation in the home country, the shares would be disqualified from being business-related. 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.

## **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 (“P.S.D.”) 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 not below 10% 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 Article 2 of the P.S.D.



Additionally, if the shares in the distributing company are deemed business-related shares under the participation exemption regime and the dividend (or capital gains 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.

An exemption also applies to dividends distributed to a foreign contractual fund (a few exemptions apply). In addition, certain funds are exempted from withholding tax when the funds are within (i) the E.E.A. or (ii) a country with which Sweden has in effect a comprehensive income tax treaty or a tax information exchange agreement. Future changes to which funds will be eligible for this exemption may be on the horizon, as the Swedish Tax Agency (“S.T.A”) has revised its view and a proposal for a new act on withholding tax on dividends is under consideration. If adopted, it may affect the assessment (see **A New Swedish W.H.T. Act** below).

### **Inbound Dividends**

Withholding tax on distributions from foreign subsidiaries is often eliminated under the P.S.D. or reduced under a double tax treaty, as shown in the treaty chart below.

### **Treaty Chart**<sup>1</sup>

Sweden currently has approximately 90 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 jurisdictions:

|                      |                |             |                   |
|----------------------|----------------|-------------|-------------------|
| Albania              | Czech Republic | Kenya       | Singapore         |
| Argentina            | Denmark        | Kosovo      | Slovakia          |
| Armenia              | Egypt          | Latvia      | Slovenia          |
| Australia            | Estonia        | Lithuania   | South Africa      |
| Austria              | Faeroe Islands | Luxembourg  | South Korea       |
| Azerbaijan           | Finland        | Macedonia   | Spain             |
| Bangladesh           | France         | Malaysia    | Sri Lanka         |
| Barbados             | Gambia         | Malta       | Switzerland       |
| Belarus              | Georgia        | Mauritius   | Taiwan            |
| Belgium              | Germany        | Mexico      | Tanzania          |
| Bermuda              | Guernsey       | Montenegro  | Thailand          |
| Bolivia              | Hungary        | Namibia     | Trinidad & Tobago |
| Bosnia & Herzegovina | Iceland        | Netherlands | Tunisia           |
| Botswana             | India          | New Zealand | Turkey            |
| Brazil               | Indonesia      | Nigeria     | Ukraine           |
| Bulgaria             | Ireland        | Norway      | United Kingdom    |
| B.V.I.               | Isle of Man    | Pakistan    | United States     |
| Canada               | Israel         | Philippines | Venezuela         |
| Cayman Islands       | Italy          | Poland      | Vietnam           |
| Chile                | Jamaica        | Romania     | Zambia            |

<sup>1</sup> The treaty concluded between Sweden and the former Kingdom of Yugoslavia remains applicable to the present-day republics of Bosnia & Herzegovina, Croatia, Kosovo, Montenegro, Slovenia, and Serbia.



|         |            |              |          |
|---------|------------|--------------|----------|
| China   | Japan      | Russia       | Zimbabwe |
| Croatia | Jersey     | Saudi Arabia |          |
| Cyprus  | Kazakhstan | Serbia       |          |

Sweden has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

### **A New Swedish W.H.T. Act**

A legislative proposal on withholding tax on dividends was referred for consultation by the Ministry of Finance on April 29, 2020.

The proposal for a new act on withholding tax on dividends means that the current Withholding Tax Act (*Sw. Kupongskattelag*) will be replaced. The purpose of the proposed act is to increase efficiency and modernize the rules on withholding tax on dividends. The proposal involves relatively significant changes to the current legislation. However, according to the bill, withholding tax on dividends will continue to be levied at 30% generally, and a direct reduction of withholding tax under tax treaties will continue to be possible where certain conditions are met.

The proposal was subject to heavy criticism and a revised proposal was published by the Swedish Ministry of Finance on June 7, 2022. The consultation period ended October 7, 2022.

The amended proposal was intended to enter into force on July 1, 2023 and be applied from January 1, 2024. However, the results of the latest consultation period have not yet been presented and in May of 2023, the Swedish Minister of Finance confirmed that the work with the new Withholding Tax Act had been delayed as the Ministry of Finance was awaiting the European Commission's proposal for a common E.U. system for withholding taxes.

## **FINANCING**

### **Loan Financing**

As a rule, interest payments are deductible. However, Sweden has general interest deduction limitation rules based on the Anti-Tax Avoidance Directive (“A.T.A.D.”) and B.E.P.S. Action Item 4. Under the general limitation rule, deduction is limited to net interest expense corresponding to 30% of the company's E.B.I.T.D.A. The general limitation applies to all debt, but with a *de minimis* rule.

In addition, a deduction is not allowed to a Swedish borrower for interest on intra-group debt unless the creditor within the group (i) is taxed on the interest income at a rate of at least 10% or (ii) is domiciled within the E.E.A. or within a country with which Sweden has an income tax treaty in effect. Regardless, a deduction may be refused if the debt structure has been put in place exclusively or almost exclusively for the group to achieve a substantial tax benefit.

Interest may not be deducted on hybrid mismatch lending transactions. The rules apply to interest payable to a foreign company with which the Swedish company has a community of interest, and where the foreign company is not taxed on the interest income due to a difference in legal classification of the payment.

**“As a rule, interest payments are deductible. However, Sweden has general interest deduction limitation rules based on the Anti-Tax Avoidance Directive.”**

Sweden does not impose withholding tax on interest payments.

From a transfer pricing perspective, the interest rates charged must be at arm's length. Interest rates charged between related parties are often challenged by the S.T.A.

### **Equity Contributions**

In addition to traditional equity investments, 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 receiving company. However, it indirectly leads to 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 gains or losses – 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 the tax basis in the shares. If the shares are business-related shares, no capital gains or losses 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 domestic or 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 refund of the amount of withholding tax paid which exceeds the amount of tax imposed on the difference between the distributed amount and the acquisition value. However, as mentioned above in **Withholding Tax**, withholding tax will be eliminated in most cases 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 is a result of Sweden becoming an E.U. Member State. However, it applies in very restricted circumstances. For a deduction to be claimed, all of the following conditions must be met:

- The foreign subsidiary must be located within the E.E.A.
- The foreign subsidiary must be liquidated.

- Until the liquidation is completed, the foreign subsidiary must have 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 must be made in connection with the tax assessment of the fiscal year during which the liquidation is completed.
- The deduction of the group contribution must be openly disclosed in the tax assessment of the parent company.
- None of the companies within the parent company's community of interests may conduct business in the domicile state of the subsidiary after the completion of the liquidation.

A loss is considered final only if the subsidiary, or another entity in the domicile state of the subsidiary, has not 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 because such a possibility is limited in time, the loss will not be considered final.

There are also limitations 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 contributions received from the subsidiary after it became wholly owned are 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 group contributions, *i.e.*, value transfers that are deductible for the payer 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.

The above applies only to N.O.L.'s incurred during past fiscal years. N.O.L.'s incurred during the current fiscal year – the year of acquisition – are not subject to any restriction.

## TRANSFER PRICING

Sweden applies a transfer pricing provision based on the O.E.C.D.'s arm's length principle. In practice, this means that prices charged between related parties must

*"A loss is considered final only if the subsidiary, or another entity in the domicile state of the subsidiary, has not utilized the loss and will not be able to utilize it in the future."*

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 (approximately €13,300 of June 18, 2024). 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 abovementioned rules will be modified as a result of the O.E.C.D.’s initiative to combat base erosion and profit shifting (the “B.E.P.S. Project”) and there is a clear trend that the S.T.A. will be more aggressive in challenging intercompany pricing and transactions. Accordingly, the S.T.A. will likely further enhance its focus on intercompany transactions and the requirements for documentation and information from the taxpayer. Additional comments on B.E.P.S. will be made separately below under **B.E.P.S.**

## CONTROLLED FOREIGN CORPORATIONS

The purpose of the Swedish controlled foreign corporation (“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 an appropriate share of the C.F.C.’s profit – as calculated under Swedish generally accepted accounting principles 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, which is 11.33% at current Swedish tax rates as of May 31, 2023. To be subject to C.F.C. taxation, the controlling entity must own or control shares representing at least 25% of the capital or votes of the foreign corporation alone or together with persons with which a communal interest exists.

There are two exceptions to the C.F.C. rules. The first exception is that, regardless of the level of taxation, a foreign legal entity will not be considered to be a C.F.C. if it is resident for tax purposes in a country mentioned on the so-called “whitelist” of countries. If Sweden has concluded a double tax treaty with a whitelisted country, the exception from the C.F.C. rules applies only to income that falls within the scope of the treaty. The second exception is that the C.F.C. rules do not apply to a corporation that 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.

## 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.

The B.E.P.S. Project initially had only an indirect effect in Sweden. This changed in 2019 when the Swedish government implemented major changes to the I.T.A. concerning corporate income tax, as explained above in **Financing**, regarding interest expense deductions.

Beyond the B.E.P.S. related legislation, it is clear that the S.T.A. is learning from the analysis and comments made by different parties, and it is expected that the S.T.A. and its Nordic counterparts will become more active in issues concerning permanent establishments, transfer pricing, and intercompany transactions. Information exchange – whether as a result of B.E.P.S., F.A.T.C.A., or the Common Reporting Standard (“C.R.S.”) – will also trigger more activities. Long term, it is assumed that the B.E.P.S. Project will trigger an increased documentation and compliance burden for taxpayers, but not necessarily much new legislation or changes to the I.T.A. It is important to keep in mind that many of the B.E.P.S. Actions will not require an actual change of law by the Swedish Parliament. Rather, changes in O.E.C.D. Guidelines will affect the customary points of reference utilized by the S.T.A. and will be implemented in judicial decisions. In this context, legislators in most countries have been driven by media attacks on the tax planning methods of multinational groups, and the likely effect is that more “double taxation” will occur in order to prevent “double nontaxation.”

## RISK TAX ON CREDIT INSTITUTIONS

As of January 1, 2022, Sweden has adopted a new risk tax for credit institutions. The law is applicable on credit institutions with a total debt that exceeds SEK 184 billion (approximately €16.3 billion as of June 18, 2024) at the beginning of the fiscal year. For financial years that started during 2022, the threshold was originally SEK 150 billion (approximately €12.9 billion as of June 23, 2023). The limit will be indexed yearly for coming fiscal years.

The taxable amount is the sum of the credit institution’s total debt at the beginning of the fiscal year. However, certain debt categories, such as intragroup debt, are not included in the calculation.

The tax rate was 0.05% for fiscal year 2022, but has since been increased to 0.06% for fiscal years beginning in or after 2023.



# DENMARK

## Author

Andrea Højgaard Jørgensen  
CORIT Advisory  
Copenhagen, Denmark

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## INTRODUCTION

Denmark is generally favorable from a company tax perspective, offering the following attributes:

- Over 80 tax treaties, many of which include a 0% or 5% withholding tax rate on dividend payments to a Danish holding company
- No corporate income tax (or other tax) levied on a resident holding company's dividends received from a subsidiary established in the European Union ("E.U."), European Economic Area ("E.E.A."), or in a tax treaty state (provided the resident holding company is the beneficial owner of the dividends)
- No withholding tax levied when the Danish holding company pays dividends to a parent company resident in the E.U./E.E.A. or in a country with which Denmark has concluded a tax treaty, according to which the withholding tax is reduced or waived

In addition to the above features, Denmark offers a favorable tax and corporate environment, including a tax exemption on certain capital gains, tax-exempt reorganizations, a favorable tonnage tax regime, no capital taxes, no requirement for notarial approval, instant and online registrations in the Companies Register, and easy and cost-efficient entry and exit for Danish holding companies.

## CORPORATION INCOME TAX

Danish resident companies are subject to tax on all income and are generally only allowed to deduct expenses related to the operations of the company. Danish-resident companies are generally taxed on their worldwide income, excluding permanent establishments and immovable property located abroad, *i.e.*, a territoriality principle prevails with respect to permanent establishments and real estate located abroad. The definition of a permanent establishment for Danish tax purposes broadly follows the definition in Article 5 in the O.E.C.D. Model Tax Convention. The corporate income tax ("C.I.T.") rate is 22%.

Nonresident companies are taxed only on profits from income sourced in Denmark.

No local income taxes are levied by cities or regions on companies or branches in Denmark.

## DEDUCTIBLE EXPENSES

As a general principle under domestic Danish tax law, costs associated with earning, securing, and maintaining taxable income are deductible (referred to as operating costs), while costs associated with the expansion of the income base are nondeductible.

Formation and start-up costs are generally nondeductible according to general principles of the domestic system. Further, participation costs are, according to Danish tax law, not deductible for tax purposes if the expenses are not considered to be incurred for the benefit of the company.

## WITHHOLDING TAX

### Outbound Dividends

Nonresident corporate shareholders are subject to a 22% withholding tax on dividends distributed from a Danish company. However, the dividend withholding tax (“W.H.T.”) is reduced to nil if the receiving foreign corporate shareholder meets the following conditions:

- The foreign corporate shareholder holds directly at least 10% of the nominal share capital of the resident company.
- The dividend payment is covered by the Directive 2011/96/E.U. on taxation applicable in the case of parent companies and subsidiaries of different Member States (“P.S.D.”) or the tax treaty existing between Denmark and the state in which the recipient is resident.

If a foreign taxpayer is entitled to a reduced dividend W.H.T., but the reduced rate is not applied, the taxpayer may be entitled to apply for a refund.

It should be noted that certain tax treaties may have higher thresholds for participation exemption, in which case the exemption granted under the relevant tax treaty may be contingent on such other threshold of ownership.

As of June 2024, Denmark has tax treaties in effect with the following jurisdictions:

|                |                |            |              |
|----------------|----------------|------------|--------------|
| Argentina      | Egypt          | Jersey     | Singapore    |
| Armenia        | Estonia        | Kenya      | Slovakia     |
| Australia      | Faeroe Islands | Kuwait     | Slovenia     |
| Austria        | France         | Latvia     | South Africa |
| Azerbaijan     | Finland        | Lithuania  | South Korea  |
| Bangladesh     | Georgia        | Luxembourg | Sri Lanka    |
| Belarus        | Germany        | Macedonia  | St. Martin   |
| Belgium        | Ghana          | Malaysia   | Sweden       |
| Bermuda        | Greece         | Malta      | Switzerland  |
| B.E.S. Islands | Greenland      | Mexico     | Taiwan       |
| Brazil         | Guernsey       | Montenegro | Tanzania     |
| Bulgaria       | Hungary        | Morocco    | Thailand     |

|                        |             |             |                |
|------------------------|-------------|-------------|----------------|
| British Virgin Islands | Iceland     | Netherlands | Tunisia        |
| Canada                 | India       | New Zealand | Turkey         |
| Cayman Islands         | Indonesia   | Norway      | Uganda         |
| Chile                  | Ireland     | Pakistan    | Ukraine        |
| China                  | Isle of Man | Philippines | United Kingdom |
| Croatia                | Israel      | Poland      | United States  |
| Curaçao                | Italy       | Portugal    | Venezuela      |
| Cyprus                 | Jamaica     | Romania     | Vietnam        |
| Czech Republic         | Japan       | Serbia      | Zambia         |

The tax treaty between Denmark and Russia was terminated as of January 1, 2024. Further, a tax treaty with France became effective as of January 1, 2024.

Denmark has concluded limited Tax Information Exchange Agreements (“T.I.E.A.’s”) with the following jurisdictions:

|                   |                        |                          |
|-------------------|------------------------|--------------------------|
| Andorra           | Dominica               | Niue                     |
| Anguilla          | Gibraltar              | Panama                   |
| Antigua & Barbuda | Grenada                | Qatar                    |
| Aruba             | Guatemala <sup>1</sup> | Samoa                    |
| Bahamas           | Hong Kong              | San Marino               |
| Bahrain           | Liberia                | Seychelles               |
| Barbados          | Liechtenstein          | St. Kitts & Nevis        |
| Belize            | Macao                  | St. Lucia                |
| Botswana          | Marshall Islands       | St. Vincent & Grenadines |
| Brunei            | Mauritius              | Turks & Caicos           |
| Cook Islands      | Netherlands Antilles   | Vanuatu                  |
| Costa Rica        |                        |                          |

Notably, treaties confined to individuals, international shipping, air transport, and Mutual Agreement Procedures have been concluded with Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Hong Kong, the Isle of Man, Jersey, and Jordan. Further, Denmark has ratified the launch of the Convention on Mutual Administrative Assistance in Tax Matters, developed by the O.E.C.D. and the Council of Europe, including the 2010 protocol.

### Anti-Tax Avoidance Provisions

#### Section 2 D in the Corporate Income Tax Act

Dividends received by a nonresident legal entity are only exempt from tax if the foreign investor meets the requirements described in **Outbound Dividends**. Consequently, some foreign investors have structured their investments in a Danish company so as to replace the dividend distribution with a repayment of a debt obligation, thereby avoiding Danish W.H.T.

<sup>1</sup> Not in force.



To counteract the effects of replacing a dividend distribution with a repayment of debt, the Danish parliament introduced a rule in Section 2 D of the Corporate Income Tax Act, which dictates that the consideration received, or deemed to have been received, by a legal entity in connection with a transfer of shares, will be reclassified as a dividend distribution in certain situations. The reclassification will be triggered in the following fact patterns:

- A legal entity transfers shares held in a group-related entity to another group-related entity for consideration consisting of valuables other than shares in the transferred group entity.
- A legal entity transfers shares to an entity without any economic risk or activity for consideration consisting of anything other than shares in the receiving group entity, if the foreign parent (seller) owns shares in the empty entity or a group entity hereof following the transfer of shares.

The above only applies if the transferring legal entity would not have qualified for exemption from withholding tax on dividends received from the transferred entity prior to the transfer.

The wording of the rule is very broad, and the rule may therefore in principle be applied in a number of scenarios where the buyer or seller is a Danish resident entity.

### Beneficial Ownership

The Danish Tax Authorities (“D.T.A.”) have had a significant focus on beneficial ownership issues with the aim of establishing a firm basis in case law for the interpretation of the concept of beneficial ownership in relation to whether dividend distributions qualify for tax exemption.

Several cases regarding beneficial ownership have found its way to the Danish Supreme Court where the focal point was whether E.U.-resident companies receiving dividends or interest payments from Danish-resident group companies were beneficial owners, and whether the Danish companies should have withheld taxes on such payments.

On the basis of these cases, the D.T.A. have brought a string of cases to litigation based on arguments produced by the Ministry of Taxation. Several of the cases – colloquially referred to as the “beneficial ownership cases” – have been litigated before the E.C.J., which rendered their (Grand Chamber) ruling in the spring of 2019 (see the judgment in joined cases C-116/16 and C-117/16).

The E.C.J. essentially rendered moot the discussion of whether the P.S.D. contains a beneficial owner requirement, by reasoning that the general principle of E.U. law, which prohibits abusive practices from benefiting from E.U. law, is applicable even if no domestic anti-abuse rule has been transposed or formulated. Furthermore, the national courts are not required to identify the beneficial owner of a dividend payment in order to refuse E.U. law benefits if a fraudulent or abusive scheme is relied upon to obtain such benefit.

In January 2023, the Supreme Court issued its decision on the appeal of one of the dividend cases (as it did on other issues closely related to the withholding tax



obligation), The Court held that the Danish implementation of the P.S.D. contained a beneficial owner requirement, arguing that the general principle of E.U. law applies to the domestic law even when no specific domestic anti-abuse provision is adopted.

As such, the withholding tax exemption does not apply in case of abuse, *i.e.*, where obtaining a tax benefit is the main purpose or one of the main purposes of the legal structure and/or the flow of funds. This seems to include a beneficial ownership requirement.

Further, the Supreme Court held that the mere fact that some of the ultimate owners were resident in a country (United States) that has a tax treaty with Denmark is not in itself sufficient to demonstrate that the legal structure cannot be used for the purpose of obtaining a tax benefit (abuse). Based on documented facts, the Supreme Court held that some of the distributed dividends must be subject to W.H.T., whereas some of the distributed dividends could be exempt, depending on whether the taxpayer could demonstrate that the ultimate owner was the “beneficial owner” and, therefore, eligible for a treaty benefit, as none of the conduit entities in the arrangement at hand had any control of the flow of funds.

### **Interests**

#### ***Paid to a Resident Recipient***

There is no withholding tax on interest paid to a resident lender by a resident borrower.

#### ***Paid to a Nonresident Recipient***

In general, Denmark does not impose a W.H.T. on interest payments. However, as a starting point, Denmark imposes a 22% W.H.T. on intragroup interest payments from a resident company to a controlling foreign corporate lender (*i.e.*, generally a company which directly or indirectly owns more than 50% of the Danish company or holds more than 50% of the voting rights) or a group company thereof.

No withholding tax is, however, imposed with respect to interest payments made to a related foreign lender protected under the Interest and Royalties Directive (2003/49) (“I.R.D.”) or a related foreign lender that enjoys the benefits of a tax treaty reduction. Interest paid to a foreign parent company may only be paid without withholding tax if the foreign company is the beneficial owner of the interests. See above for an elaboration on the beneficial ownership requirement.

#### ***Beneficial Ownership***

Interest paid to a foreign parent company may only be paid without withholding tax if the foreign company is the beneficial owner of the interests. See **Anti-Tax Avoidance Provisions** for further details on beneficial ownership regarding dividends.

Several cases have been litigated concerning the beneficial ownership requirement present in the I.R.D.<sup>2</sup> The E.C.J. gave little attention to the beneficial owner requirement contained in the I.R.D., reasoning that the general principle of E.U. law, which prohibits abusive practices from benefiting from E.U. law, was applicable regardless of whether a domestic anti-abuse rule had been transposed or formulated.

<sup>2</sup> See the judgment in joined cases C-115/16, C-118/16, C-119/16 and C-299/16.

*“ . . . the withholding tax exemption does not apply in case of abuse, i.e., where obtaining a tax benefit is the main purpose or one of the main purposes of the legal structure and/or the flow of funds.”*

Furthermore, the national courts are not required to identify the beneficial owner of an interest payment in order to refuse E.U. law benefits if a fraudulent or abusive scheme is relied upon to obtain such benefit.

### **Royalties**

#### ***Paid to a Resident Recipient***

There is no W.H.T. on royalties paid to a resident recipient.

#### ***Paid to a Nonresident Recipient***

Generally, foreign companies are subject to a 22% W.H.T. on royalty payments from Danish companies. The definition of a royalty includes payments of any kind received as remuneration for the use of, or the right to use, patents, trademarks, designs or models, secret formulas or processes, or information on industrial, commercial, or scientific experiences. The definition only includes payments for the use of or the right to use the abovementioned rights; conversely, the definition does not include the sale of such rights itself.

However, the rule does not apply to royalty payments made to a related foreign recipient protected under the I.R.D. or a related foreign recipient that enjoys the benefits of a tax treaty reduction. Note that beneficial ownership requirements on interest payments, also apply to royalties.

## **TAXATION OF INBOUND DIVIDENDS**

Shareholdings of corporations are divided into the following categories:

- Group shares defined as shares in a company in which the shareholder of the company and the company itself are subject to Danish joint taxation or fulfill the requirements for international joint taxation under Danish tax law
- Subsidiary shares defined as shares owned by a company holding at least 10% of the nominal share capital of the subsidiary which is resident in Denmark or resident and taxable in a country which exchanges information with Denmark according to an international agreement
- Tax-exempt portfolio shares defined as non-listed shares owned by a company holding less than 10% of the nominal share capital
- Taxable portfolio shares defined as shares that do not qualify as group shares, subsidiary shares, or tax-exempt portfolio shares, e.g., listed shares owned by a company holding less than 10% of the nominal share capital
- Trading shares defined as shares owned by a company engaged in a systematic, professional, and extensive business of buying and selling shares, including these specific shares

All dividends received on subsidiary shares and group shares are tax exempt (irrespective of the holding period). All dividends received on tax-exempt portfolio shares are partly tax exempt as only 70% of the dividends are taxable (30% are tax exempt). All dividends paid on taxable portfolio shares are subject to Danish corporate income taxation at a rate of 22%.

Resident companies that have acquired shares in the capacity of a professional trader in shares, *i.e.*, trading shares, are also eligible for the participation exemption if these requirements are met.

When shares are sold back to the issuing company, the proceeds are treated as dividends. However, the D.T.A. may on application grant exemption from tax, and the transaction may be treated as a disposal of shares. This also applies to individual shareholders.

Lastly, companies should be aware when shares are sold between related companies or the buying company is without economic risk and activity (*e.g.*, a bare holding company), as the purchase price in some instances will be reclassified to a dividend distribution from the buyer to seller (see **Anti-Tax Avoidance Provisions**).

### **Anti-Tax Avoidance Provision**

Certain anti-avoidance provisions are introduced in sections 4A(3) and 4B(2) of the Act on Taxation of Capital Gains on Sale of Shares in order to prevent structures established for the sole purpose of meeting the 10% threshold and thereby qualifying for tax exemption as subsidiary shares or group shares.

The anti-avoidance provisions target holding structures where the majority of the company is held, directly or indirectly, by resident companies that would not otherwise qualify for the participation exemption were they the direct shareholders of the target.

The anti-avoidance provisions apply to such structures under the following cumulative conditions:

- The primary objective of the interposed holding company is to own shares in subsidiaries or other group-related companies.
- The interposed holding company is deemed to have no “genuine economic activity.”
- The interposed holding company does not own all the shares in a subsidiary, or the interposed holding company owns all shares in a subsidiary which is not tax resident in Denmark and dividends from the foreign subsidiary, if owned directly by the parent company, would not be waived or reduced pursuant to the P.S.D. or an applicable tax treaty concluded with the state in which the subsidiary is resident.
- The shares of the interposed holding company are neither listed nor traded on a regulated market or a multilateral trading facility.
- More than 50% of the share capital of the interposed holding company is owned, directly or indirectly, by entities which are tax resident in Denmark (including, *e.g.*, foreign entities’ permanent establishments) which would not individually meet the 10% ownership condition if the shares were owned directly.

If more than one step in the chain of ownership is disregarded according to the above rules, the ultimate owner is considered to be the direct shareholder for taxation purposes. Accordingly, the rules do not entail adverse double taxation.

The rules also contain provisions which prevent circumvention of the rules by way of using multiple share classes.

Similar anti-avoidance provisions are introduced in section 4C(4) of the Act on Taxation of Capital Gains on Sale of Shares in order to prevent structures that are established for the sole purpose of meeting the condition of “unlisted shares,” thereby allowing otherwise taxable portfolio shares to qualify as tax-exempt portfolio shares. Consequently, the value of the portfolio company’s ownership in listed shares must not exceed 85% of the portfolio company equity at the end of the financial year.

## C.F.C. TAXATION

### **Scope and Conditions of Applicability**

The C.F.C. rules provide that C.F.C. income generated by a subsidiary may be attributed to the taxable income of the Danish company (C.F.C. taxation).

C.F.C. taxation is levied in the form of a mandatory tax consolidation of a Danish company (“Danish HoldCo”) holding a qualifying interest (see below) in a subsidiary (“SubCo”). Mandatory tax consolidation implies that SubCo’s net income, if positive, must be included in the taxable income of Danish HoldCo. If SubCo is not wholly owned by Danish HoldCo, the relevant income to be included proportionally based on Danish HoldCo’s percentage ownership of shares of SubCo.

With effect from income years commencing on January 1, 2021, onwards, the Danish C.F.C. rules were amended to be in line with the Anti-Tax Avoidance Directive (2016/1164) (A.T.A.D.). The main amendments comprised the abolishment of the so-called C.F.C. financial asset test and a reduction of the C.F.C. income to one third of the subsidiary’s taxable income. Further, a partial substance test was introduced.

Generally, C.F.C. taxation applies if the following two conditions are met:

- Danish HoldCo is a shareholder and directly or indirectly controls SubCo (C.F.C. control test).
- The C.F.C. income of SubCo exceeds more than one third of the aggregate taxable income of SubCo (C.F.C. income test).

The definition of when a shareholder is considered to directly or indirectly control SubCo generally follows the A.T.A.D.

Further, the definition of C.F.C. income generally follows the A.T.A.D., but it should be noted that Denmark has chosen to include the wording concerning “other income derived from I.P. rights” in the definition of C.F.C. income. Further, instead of a substance carve out, as known from A.T.A.D., a partial substance test was introduced in section 32(5), number 3 of the Corporate Income Tax Act enacted in 2021. This partial substance test implies that other income derived from I.P. rights should only be considered C.F.C. income under certain conditions, which generally relates to whether there is any substance in SubCo.

### **Recapture of C.F.C. Taxation**

Special provisions apply in the case of a sale of shares of a SubCo to an unrelated party occurring in a year when SubCo meets the C.F.C. conditions. Pursuant to



section 32(10) of the Danish Corporate Income Tax Act, Danish HoldCo shall consider and include in its taxable income not only the potential gain on the shares but also a deemed C.F.C. income item, as if the financial assets of SubCo had been sold in an asset sale transaction.

The resulting tax burden is alleviated by a credit of the domestic taxes which would have been levied on SubCo if such an asset sale transaction had occurred. The purpose of section 32(10) is to prevent Danish HoldCo from transferring financial assets to SubCo and avoiding Danish taxation of the gains on such assets by realizing such gains as part of the tax-exempt gains on the shares of SubCo, on the assumption that Danish HoldCo holds at least 10% of the share capital in SubCo and thereby qualifies for the participation exemption regime.

## CAPITAL GAINS TAXATION

### **Domestic Subsidiaries**

As a rule, capital gains are subject to tax only if the shares have been realized or disposed of. Shareholdings of corporations are divided into the categories as described in **Taxation of Inbound Dividends** above, for the purpose of determining capital gains taxation.

Any change of status (classification) from subsidiary shares, group shares, or tax-exempt portfolio shares to taxable portfolio shares, or from taxable portfolio shares to subsidiary shares, group shares, or tax-exempt portfolio shares, will be treated as a transfer and repurchase of shares (thereby in the process realizing a capital gain/loss and acquiring a new purchase price) according to section 33A of the Act on Taxation of Capital Gains on Sale of Shares.

See further specific Anti-Tax Avoidance Rules in **Anti-Tax Avoidance Provisions**.

### **Subsidiary, Group, and Tax-Exempt Portfolio Shares**

A resident company is tax exempt on the receipt of all capital gains realized on the transfer of subsidiary shares, group shares, and tax-exempt shares, irrespective of the ownership period.

### **Portfolio Shares and Trading Shares**

Resident corporations are taxable on capital gains on trading shares and taxable portfolio shares (for example listed portfolio shares). The mark-to-market principle applies to taxable portfolio shares and trading shares. Losses realized on shares subject to taxation under the mark-to-market principle may be used to offset ordinary business income of a company. However, there is a one-off opportunity to elect taxation according to the realization principle for all unlisted shares.

Losses are generally tax deductible.

To counter attempts to avoid taxation, non-listed portfolio shares will not be classified as tax-exempt portfolio shares if listed shares make up more than 85% of the value of the equity in the non-listed portfolio company at the end of the financial year.

## INTEREST DEDUCTIBILITY LIMITATIONS

Interest expenses are generally deductible from taxable income, provided the debt involves a genuine legal commitment and the interest is calculated based on the remaining debt. Interest paid to related parties must be calculated on an arm's length basis.

The following interest deductibility limitations apply.

### **Thin Capitalization**

The thin capitalization rules, laid down in section 11 of the Corporate Income Tax Act, apply to legal entities that are tax resident in Denmark and foreign legal entities that are subject to limited Danish tax liability due to the existence of a permanent establishment in Denmark. In the following discussion, both types of entities are referred to as the “resident debtor.”

The thin capitalization restrictions apply to a resident debtor if the following four conditions are met:

- The resident debtor has a debt to a group-related legal entity (controlled debt).
- The controlled debt exceeds a threshold of DKK 10 million.
- The resident debtor's debt-to-equity ratio exceeds 4:1 at the end of the tax year (market values).
- The resident debtor cannot prove that “similar debt” could be obtained between unrelated parties.

Where these conditions are met, the deductibility of interest payments and capital losses in respect to the excessive controlled debt is restricted.

The thin capitalization rule is applied on a consolidated basis. This means that the debt-to-equity ratio is calculated on a consolidated basis for the resident debtor and other controlled Danish entities that can be considered part of the same tax group. However, the foreign parent company or, if applicable, the ultimate resident parent company of the group is disregarded for the purposes of this consolidation. The consolidation rule also states that debt and interest between parties of the consolidation is disregarded in the calculation of the controlled debt as well as in calculating the actual interest limitation according to the thin capitalization rule as described below.

If the thin capitalization restrictions apply, the resident debtor cannot deduct interest expenses and capital losses relating to the part of the controlled debt that would have to be converted into equity to meet the 4:1 ratio.

Following the E.C.J. case Masco (C-593/14), interest and capital gains are tax exempt if a foreign debtor, resident in another E.U./E.E.A. country, is restricted by the national thin capitalization rules, *i.e.*, if the debtor is liable for tax in Denmark and is restricted by thin capitalization rules in the other E.U./E.E.A. country. It should be noted that it is the position of the Danish tax authorities that the corresponding

*“Interest expenses are generally deductible from taxable income, provided the debt involves a genuine legal commitment and the interest is calculated based on the remaining debt.”*

tax-exempt interest income must be computed as if both the thinly capitalized entity and the lender entity were Danish companies, including the observance of the consolidation rule described above.

Regardless of whether the 4:1 debt-to-equity ratio is exceeded, the thin capitalization restrictions do not apply to interest payments that are subject to Danish W.H.T.

The nondeductible interest expenses are not recharacterized as a distribution of profits for domestic law or tax treaty purposes. Accordingly, dividend W.H.T. is not imposed on the nondeductible interest under the domestic law or an applicable treaty.

#### Controlled Debt (Condition 1)

The term “controlled debt” means debt owed by a resident debtor to a Danish or foreign legal entity, which

- is controlled by the debtor,
- controls the debtor, or
- is under common control with the debtor.

“Control” generally means that more than 50% of the shares or voting rights are directly or indirectly owned or controlled. The voting rights of other shareholders with whom the creditor has an agreement to exercise joint control over the debtor must also be included when assessing whether the creditor has control (note that the concept of “control” is the concept that also applies to transfer pricing).

Further, “controlled debt” includes debt owed to a third party if a related legal entity has provided, directly or indirectly, security for such a loan. Indirect security includes back-to-back arrangements where an affiliated company agrees to provide security to a third party that has granted a loan to the Danish entity. This will also be the case if the related legal entity deposits an amount with a bank corresponding to a loan granted by such a bank to the resident debtor, for example, in certain cash pools arrangements. The focal point is whether there is a connection between the loan granted to the Danish debtor and the security provided by a related legal entity.

#### Debt-to-Equity Ratio (Condition 2)

The definition of “debt” includes those items identified in the Act on Taxation of Gains on Debt and Claims, and convertible bonds. Debt is assessed at market value at the end of the company’s tax year. It is computed as the aggregate sum of the controlled debt and all other debt. Debt in foreign currency is converted into DKK at the exchange rate applicable at the end of the company’s tax year.

For the purpose of establishing the debt-to-equity ratio, “equity” means all assets minus all debts. The assets are assessed at market value at the end of the company’s tax year. The value of listed shares is the listed market value.

For permanent establishments of nonresident companies, only assets and liabilities that are allocated to the permanent establishment are taken into account for purposes of computing the debt and equity of the permanent establishment.



## **Asset Limitation Rule**

Net financing expenses as defined below are not deductible if they exceed a cap computed by applying a standard rate of return (2.7% for 2023 and 6% for 2024) on the tax base of the company's qualifying assets, also defined below.

A company's net financing expenses consist of a possible negative total of the following incomes and expenses:

- Net interest expenses (excluding interest payments to and from trade creditors and debtors)
- Loan commissions and similar expenses or income (excluding commissions related to trade accounts payable or receivable)
- Taxable capital gains and losses on receivables, debts, and financial instruments (exceptions apply)
- Estimated finance costs or income relating to financial leasing arrangements (defined in accordance with the former I.A.S. 17)
- Taxable capital gains and used losses on shares or other items taxed according to the Capital Gains Act<sup>3</sup>

If net financing expense, calculated on a group basis, is below DKK 21.3 million, deductibility should not be limited under the asset limitation rule.

The qualifying assets include the following:

- The tax base of depreciable assets at the end of the income year
- The acquisition price of nondepreciable assets with any expenses paid for improvements
- The value of works-in-progress, assets bought for trading purposes (only shares taxed according to the mark-to-market principle are included), inventory and receivables if the value exceeds debts related to acquired works-in-progress, assets bought for trading purposes, inventory, and receivables
- The value of any tax losses which would be carried forward by the company without the application of the asset and E.B.I.T.D.A. limitation rules
- The book value of leased assets included by the lessee in a financial leasing arrangement (however, with respect to assets subject to financial leasing between group related companies, the tax value is used rather than the book value)
- The tax base of assets injected into the Danish tax consolidated group by a foreign group company if the assets remain in the Danish consolidated tax

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<sup>3</sup> However, if such net amount of gains and losses is negative, it is not included in the calculation of the net financing expenses of the year in question – instead such negative amount is carried forward. This rule does not apply to equities bought by a trader for trading purposes if taxed according to the mark-to-market principle.

group for more than two years; this restriction does not apply if the group has chosen international tax consolidation

Qualifying assets exclude the following:

- Shares other than shares forming part of a financial trading activity may be included in the calculation if these are taxed according to the mark-to-market principle
- Receivables
- Cash
- Bonds and financial instruments (forwards, swaps, etc.)
- Assets held and leased out by a lessor under a finance lease
- Assets injected into the Danish consolidated tax group by a foreign group company if the assets remain in the Danish consolidated tax group for less than two years
- Shipping assets subject to taxation under the Tonnage Tax Act

The value of the assets must be determined as the tax value at the end of each tax year.

Net financing expenses that are restricted as a result of the asset limitation rule may not be carried forward. However, net capital losses relating to debts (including F.X. losses) and financial instruments that have been reduced under the asset limitation rule may be carried forward for three tax years to set off gains on debts (including F.X. gains) and financial instruments. Nonetheless, unrealized losses on interest swaps regarding debt secured with collateral in real property can be carried forward during the term of the interest rate swap to set off any future increase in unrealized gains on the same swap. When restricting the deductibility of net financial expenses, losses relating to net debts and financial instruments are reduced first. When setting off carry forward losses against future gains, the oldest losses are set-off first.

For companies that are part of a Danish tax consolidation, the calculation of the tax base of the assets will be made on a consolidated basis. Danish group companies are subject to a mandatory tax consolidation regime.

### **E.B.I.T.D.A.**

In addition to any limitations triggered by the thin capitalization rule and/or the asset limitation rule, the exceeding borrowing costs must comply with the E.B.I.T.D.A. limitation. Under the E.B.I.T.D.A. limitation, financing costs must not exceed more than 30% of the E.B.I.T.D.A.

In relation to the E.B.I.T.D.A. rule, a company's excess financing costs consist of the following incomes and expenses:

- Net interest expenses (excluding interest payments to and from trade creditors and debtors)
- Loan commissions and similar expenses or income (excluding commissions related to trade accounts payable or receivable)



- Taxable capital gains and losses on receivables, debts, and financial instruments (exceptions apply)
- Estimated finance costs or income relating to financial leasing arrangements (defined in accordance with the former I.A.S. 17)

Excess financing costs that are limited by the E.B.I.T.D.A. limitation rule may be carried forward. Similarly, surplus E.B.I.T.D.A. capacity to absorb interest deductions may be carried forward to offset limited interest deductions in subsequent income years.

Companies that are parties to a tax consolidation must compute their net financing expenses on an aggregate basis, which is then reduced proportionally according to the E.B.I.T.D.A. rule. A minimum allowance of DKK 22,313,400 (approximately €3 million) may always be deducted.

Furthermore, companies which are parties to a tax consolidation may opt to replace the 30% E.B.I.T.D.A. threshold with a group ratio, computed as the consolidation companies' total net financing expenses divided by the tax consolidation companies' E.B.I.T.D.A. result. This computation must be based on the consolidated financial statement.

### **Calculation of Net Financial Expenses and Excess Debt Funding Costs**

For the purposes of the Asset Limitation Rule, net financial expenses are calculated as the sum of the following items:

- Taxable interest income and deductible interest expense, excluding interest income/expense from/to 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, as defined in accordance with I.A.S. 17
- Taxable capital gains and deductible capital losses
- Taxable dividends

For the purpose of the E.B.I.T.D.A. Limitation Rule, excess debt funding costs include each of the following items:

- Taxable interest income and deductible interest expense, excluding interest income/expense 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, as defined in accordance with I.A.S. 17

Interest expense and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses and the excess debt funding costs. The calculation of net financial expenses and excess debt funding costs 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 (€2,859,767 as of 2024), or in regard to excess debt funding costs, DKK 22,313,400 (€2,995,827 as of 2024), such net financial expenses will be subject to restrictions under the Asset Limitation Rule, the E.B.I.T.D.A. Limitation Rule, or both, as discussed below.

## TAXATION OF PAYMENTS TO NONCOOPERATIVE TAX JURISDICTIONS

Denmark has in place certain defensive measures directed at countries on the E.U. list of noncooperative tax jurisdictions. Deductible or depreciable payments are non-deductible and nondepreciable, respectively, where the beneficial recipient of the payment is a tax resident in any of the following jurisdictions:<sup>4</sup>

|                   |        |                        |
|-------------------|--------|------------------------|
| American Samoa    | Guam   | Seychelles             |
| Anguilla          | Palau  | Turks & Caicos Islands |
| Antigua & Barbuda | Panama | Trinidad & Tobago      |
| Bahamas           | Russia | U.S. Virgin Islands    |
| Belize            | Samoa  | Vanuatu                |
| Fiji              |        |                        |

The above list is updated twice each year to track updates regarding the E.U. list of noncooperative tax jurisdictions.

Outbound dividends paid by a Danish resident company is subject to W.H.T of 44%, if

- the beneficial owner of the shares is a tax resident in one of the abovementioned jurisdictions, or

<sup>4</sup> The jurisdictions listed apply for Danish tax purposes, but the E.U. list of noncooperative tax jurisdictions was last updated as of February 20, 2024. According to the Danish Ministry of Taxation, the Bahamas and Turks & Caicos Islands have been removed from the E.U. list; Albania, Aruba, Botswana, Dominica, Hong Kong, and Israel have been removed from the list of observation; and Belize and Seychelles have been moved from the E.U. list of noncooperative tax jurisdictions to the list of observation. The Danish Tax Agency does not include Antigua & Barbuda but includes Costa Rica on the list of noncooperative tax jurisdictions.

- the shareholder is a company in which the majority shareholder is a resident of one of the abovementioned jurisdictions or is controlled by a company resident in one of the abovementioned jurisdictions.

## BASE AND EROSION PROFIT SHIFTING (B.E.P.S.)

Denmark has implemented multiple B.E.P.S. actions in domestic Danish tax law.

Regarding B.E.P.S. Action Item 2 on hybrid mismatches, refer to **Hybrid Mismatches**.

With respect to B.E.P.S. Action Item 3 on C.F.C. taxation, refer to **C.F.C. Taxation**.

Regarding B.E.P.S. Action Item 4 concerning limiting base erosion via interest deductions, refer to **Interest Deductibility Limitations**.

With respect to B.E.P.S. Action Item 5, Denmark does not offer lower tax rates for income derived from I.P., since Denmark does not have a patent box regime. Instead, an increased deduction applies to R&D costs. Denmark has concluded a number of T.I.E.A.'s to exchange information; refer to **Outbound Dividends**.

With respect to B.E.P.S. Action Item 6 on preventing treaty abuse, refer to **Beneficial Ownership** and **General Anti-Abuse Rule**.

With respect to B.E.P.S. Action Items 8, 9, and 10, refer to **Transfer Pricing**.

Denmark has ratified the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

## GENERAL ANTI-ABUSE RULE

Denmark has implemented a G.A.A.R. in section 3 of the Tax Assessment Act. This means that whereas previously only arrangements concerning benefits obtained under E.U. law could be countered by way of the G.A.A.R., henceforth purely domestic arrangements are covered as well.

The introduction of a G.A.A.R. indicates a change in the domestic tax legislation which so far used specific anti-avoidance rules and certain doctrines established through case law. The G.A.A.R. implements the anti-avoidance clause introduced in A.T.A.D. (section 3(1)) and the principal purpose test from B.E.P.S. Action Item 6 (section 3(4)). The principal purpose test (“P.P.T.”) is intended to counter avoidance structures utilizing treaty shopping or similar treaty based abusive tax planning structures.

Under the application of the G.A.A.R., taxpayers will not be entitled to claim the benefits granted under any domestic statute, the E.U. directives on direct taxation, or any tax treaties entered into by Denmark.

In particular, the G.A.A.R. applies to an arrangement or series of arrangements that, having been put into place with the main purpose or one of the main purposes being to obtain a tax advantage that defeats the content, object, or purpose of the relevant directive, are not genuine considering all relevant facts and circumstances.

*“Denmark has implemented multiple B.E.P.S. actions in domestic Danish tax law.”*

The Minister of Taxation has stated that in a specific Danish context, the G.A.A.R. can only be applied to the extent that the tax advantage is obtained in Denmark. Consequently, in situations where a directive on direct taxation or a tax treaty is used to obtain tax benefits outside Denmark, these tax benefits are not covered by the Danish implementation of the G.A.A.R.

## HYBRID MISMATCHES

Denmark deploys a sophisticated network of hybrid mismatch rules, which were updated to reflect the contents of the first A.T.A.D. as amended with regard to hybrid mismatches with third countries by the second A.T.A.D. (in this section referred to as “A.T.A.D. 2”). The prior set of anti-hybrid rules focused on the divergent (hybrid) classification of an entity or an interest payment, while the current set of anti-hybrid rules focus on an actual hybrid outcome (double deduction, deduction/non-inclusion, or double non-inclusion).

While the prior anti-hybrid rules were already robust and to a large extent met the minimum standards contained in the directive, the Danish parliament chose to do a full rewrite of the rules and introduced the precise system laid out in A.T.A.D. and A.T.A.D. 2.

Therefore, section 8C of the Corporate Income Tax Act currently contains a list of arrangements or transactions that constitute hybrid mismatches. These include a variety of deduction/non-inclusion arrangements, double deductions, and double non-inclusions. The rules are structured to encompass vanilla hybrids, as well as reverse and imported mismatches, and lastly, they encompass hybrid mismatches arising based on residency and jurisdictions. Overall, the Danish hybrid rules are highly complex – as are A.T.A.D. and A.T.A.D. 2 – and are designed to prevent any hybrid mismatch arrangement from being implemented through Denmark.

Due to the heavy reliance on A.T.A.D. and B.E.P.S., the primary linking rule and the defensive linking rule are the prevalent mechanism by which Denmark negates the effect of hybrid mismatches. A detailed analysis of the hybrid mismatch rule would exceed the scope of this chapter. Suffice it to say that the rules are designed to rectify the advantage of a mismatch result, *i.e.*, if the result is a deduction/non-inclusion, Denmark will either deny the deduction if the income is not included in the recipient state, or include the income if the income gives rise to a deduction without inclusion, depending on the type of mismatch.

Lastly, Danish hybrid mismatch rules contain a provision according to which income attributable to a disregarded permanent establishment abroad is included, *i.e.*, a deviation from the limited territoriality principle.

While the Danish hybrid mismatch rules are highly complex and broad in scope, it is yet to be seen how the implementation of the A.T.A.D. and A.T.A.D. 2 will impact Danish case law going forward. The legislature has chosen to implement rules transposed from the directives and the B.E.P.S. Report. As a result, tax authorities and the courts likely will rely on those resources for guidance.

## TRANSFER PRICING

Under domestic law, transactions between related parties must be carried out in accordance with the arm's length principle (section 2 of the Tax Assessment Act) which generally follows the principles as set out in the O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2022) ("O.E.C.D. Guidelines").

### **Documentation**

When filing tax returns, a company must report the type and scope of its intercompany cross-border transactions. In addition, it must document the price calculation and conditions applicable to intercompany cross-border transactions. The annual transfer pricing documentation, comprised of a local file and a master file, must be submitted to the D.T.A. not later than 60 days after filing the tax return. Regardless of nationality, small companies, , are required to produce written documentation only if they are engaged in controlling cross-border transactions with individuals or entities resident in countries with which Denmark has no tax treaty, and which are not resident in an E.U. or E.E.A. Member State.

Small companies include companies that, on a consolidated basis, have fewer than 250 employees and either a yearly balance of less than DKK 125 million (approximately €16.8 million) or a yearly turnover of less than DKK 250 million (approximately €33.6 million).

The tax authorities have issued guidance setting forth the documentation requirements (see the Order on Transfer Pricing Documentation). Generally, the requirements are in line with the content requirements of the local file and the master file in the O.E.C.D. Guidelines.

The documentation may be submitted in Danish, Swedish, Norwegian, or English.

If the transfer pricing documentation is considered to be insufficient, the Danish tax authorities may reassess the taxable income based on a discretionary assessment. If the taxable income is subject to a discretionary assessment, the burden of proof will be reversed. Failure to submit timely and compliant transfer pricing documentation may result in penalties and a discretionary assessment.

The penalty for noncompliance is calculated on the basis of different objective criteria and on the potential tax advantage. A fixed penalty of DKK 250,000 is introduced (basic amount) plus 10% of the increased income for failure to submit documentation, or if the submitted transfer pricing documentation is insufficient; however, the penalty can potentially be reduced to DKK 125,000 if sufficient documentation is provided at a later stage.

## FISCAL CONSOLIDATION/GROUP TREATMENT

### **Mandatory Local Tax Consolidation**

All Danish resident group-related companies and branches of foreign companies are subject to the mandatory local tax consolidation regime.

“Danish entities” (*i.e.*, resident companies and branches of foreign resident companies) are considered to be group-related if they are part of the same “group.” The “group” definition is comparable to the corresponding definition set out in the International Accounting Standards (“I.A.S.”) and is broadly similar to the definition contained in the International Financial Reporting Standards (“I.F.R.S.”).

A “group” is considered to exist where a company, foundation, association, trust, etc., is the parent company to one or more subsidiaries. Thus, the definition covers resident entities which do not have a common resident parent company but have a common foreign parent company, *i.e.*, resident sister companies.

A company may only have one direct parent company. If several companies meet one or more of the criteria to be a parent company, only the company exercising the actual controlling interest over the subsidiary’s financial and operational decisions will be considered the parent company.

A controlling interest is the right to control a subsidiary’s financial and operational decisions. A controlling interest exists where the parent company, directly or indirectly, owns more than half of the voting rights in a company, unless it is clearly demonstrated that such ownership does not constitute a controlling interest.

If a parent company does not own more than half of the voting rights in a company, it will still be considered to hold a controlling interest if any of the following rights are held:

- A right to dispose of more than half of the voting rights by virtue of an agreement concluded with other investors
- A right to control the financial and operations affairs of the company pursuant to an article of association or an agreement
- A right to appoint or remove the majority of the members of the supreme management body and said body has a controlling interest in the company
- A right to dispose of the actual majority of the votes at the general meeting or in any similar body, giving it the actual controlling interest in the company

The existence and impact of potential voting rights, including subscription rights and call options relating to shares which may immediately be exercised or converted, must be taken into consideration when assessing whether a company has a controlling interest. When calculating the voting rights in a subsidiary, any voting rights attaching to shares held by the subsidiary or by its subsidiaries are disregarded.

Companies deemed to be trading in shares or other financial institutions may in some cases be exempt from tax consolidation to preclude financial institutions and other entities deemed to be engaged in the trade of shares from being able to obtain double deductions. Generally, losses realized on debt to controlled parties are not deductible for tax purposes. However, if a company – as defined in section 4(5) of the Act on Taxation of Capital Gains on Debt and Claims, *i.e.*, companies deemed to be trading in shares or other financial institutions – acquires another company and thereby assumes control over that company, the general rule prohibiting the deductions of such losses does not apply. As such, the acquiring company can deduct losses on the debt and could – without the special provision – also utilize any losses realized in the acquired company or group of companies hereof to offset the income

**“A company may only have one direct parent company.”**



of the acquiring company. Correspondingly, the acquired company, along with any subsidiaries or other affiliated entities of such company, is not considered to be a subsidiary of the acquiring company pursuant to the rules of (mandatory) tax consolidation, and therefore it is not included in the acquiring company's tax consolidation.

### Consequences of Part Ownership

The taxable income of an entity in a tax group is to be included in the tax-consolidated income irrespective of the percentage of ownership. The entire taxable income is to be included regardless of whether or not the parent company has an ownership interest of 100%.

### Group Relation Established During the Income Year

If a qualifying group relation is established during the income year, only the income corresponding to the qualifying period is, as a general rule, to be included in the tax-consolidated income.

### Consolidated Income

The consolidated income is determined by calculating the taxable income separately for each entity of the group and then pooling the taxable results. Before pooling the taxable results, however, these amounts are adjusted by offsetting each entity's separate carryforward losses, if any, against that entity's taxable result.

Losses from the current tax year of an entity in the group are transferred proportionally to profit-making entities. Losses that cannot be set off against the income of profit-making entities are allocated proportionally to loss-making entities to be set off against future profits of these entities.

Losses of an entity incurred before the inclusion in a group may be set off only against that entity's own future profits.

Companies have a limited possibility to offset and carry forward losses against positive income. A loss of up to DKK 9,135,000 per year (in 2023) and DKK 9,457,500 per year (in 2024) can always be offset against positive income, and the remaining loss can, at most, reduce the remaining income by 60%. It is possible to carry forward losses indefinitely. Under domestic law, carry-back is generally not allowed, except under certain circumstances for entities covered by the Hydrocarbon Tax Act.

### Group Contributions

A group contribution is normally treated as a nondeductible expense, a capital contribution, or a distribution for the contributor. For the recipient, a contribution is either treated as a taxable capital contribution, a tax-exempt contribution, or as a dividend distribution, which may be tax exempt for the recipient if the recipient qualifies for an exemption under the participation exemption regime.

The same position applies to payments under a guarantee issued by a parent to cover the losses of a subsidiary. Thus, if the payments are in fact a capital contribution to the subsidiary, no deduction is allowed. On the other hand, a deduction may be allowed if there is a close connection between the activities of the loss-making subsidiary and the income-generating activities of the parent.

### *Appointment of an Administration Company*

An entity of the group is appointed as the so-called administration company. If the ultimate parent company of the group is a Danish resident company, this company will be appointed. If there is no ultimate resident parent company but several resident sister companies, one of the sister companies is appointed.

The administration company is responsible for the filing of tax returns for the group.

The administration company is also responsible for the payment of taxes charged on the tax-consolidated income, including advance payments of taxes. All members of the tax group are jointly and severally liable for the members' corporate income taxes and withholding taxes as described below.

### *Payment of Taxes*

The administration company is responsible for the remittance of the payment of all taxes charged on the tax-consolidated income to the tax authorities. This means that the other entities of the group are required to pay their share of the total tax due to the administration company. If the entity's taxable profit is offset by tax losses of other entities in the group (and therefore has not created a tax charge), the administration company pays an amount corresponding to the tax value to the members whose losses have been utilized to offset the tax.

This latter contribution is also borne by the group entity, the income of which has been offset by using the tax loss in question, which must pay the administration company. In turn, the administration company is to pay to the loss-making entity an amount corresponding to the tax value of the loss utilized by other entities in the group.

The rules on domestic tax consolidation prescribe that payments to loss-making entities (for the utilization of tax losses) must be made by the due date applicable to the payment of corporate taxes by the administration company. If the payment is not made by this date, interest (fixed on market terms) must be paid to the loss-making entities. The rules do not explicitly mention a due date for payments by the profit-making entities to the administration company. The legislative remarks, however, suggest that these payments are also to be made by the due date applicable to the payment of corporate income taxes by the administration company.

### *Liability for Tax Charges*

In cases where all shares are directly or indirectly owned by the ultimate parent at the end of the income year, the administration company and the entities included in the tax consolidation are jointly and severally liable with the company for the tax charges, including withholding taxes, plus the surcharges and interest allocated to the company in that income year. Entities within the group other than the administration company and wholly-owned entities are liable on a subordinated and *pro rata* basis.

### **Optional Cross-Border Tax Consolidation**

Cross-border tax consolidation is optional. The regime introduces a worldwide full consolidation principle requiring all foreign group entities to be included in the tax consolidation group for a period of ten years.

The worldwide full consolidation principle is not limited to foreign subsidiaries but applies to all foreign group entities, including foreign parent companies and sister companies, and foreign permanent establishments as well as foreign immovable property. The fact that the cross-border tax consolidation also applies to upstream entities can make the regime unattractive to foreign-controlled Danish groups.

Foreign entities are considered to be group-related if they meet the group definition set out in the rules on domestic tax consolidation.

### Consequences of Cross-border Tax Consolidation

As a starting point, the consolidated taxable income is determined in accordance with the principles that also apply to domestic tax consolidation, and the same rules apply to the appointment of an administration company, liability for tax charges, etc. This is, however, subject to the rules contained in section 31 A of the Corporate Income Tax Act.

The decision to form a cross-border tax consolidation is binding for a period of 10 years. If the cross-border tax consolidation is discontinued within the 10-year period, stricter recapture rules apply than the recapture rules that would apply if the tax consolidation was discontinued immediately after the 10-year period, as the taxation of the utilized losses are not limited to liquidation proceeds when discontinuing the cross-border tax consolidation after 10 years.

### Recapture of Losses

Tax losses of foreign group members are recaptured in full when tax consolidation is terminated, but the recaptured losses cannot exceed the fictitiously calculated liquidation proceeds if the termination is due to the cross-border tax consolidation not being renewed after 10 years.

Complex transition rules apply to the recapture of losses in connection with the termination of cross-border tax consolidations that were established under the previous tax consolidation regime.

### Partial Abandonment of the Principle of Worldwide Income Taxation

The objective of the worldwide full consolidation principle is to prevent Danish resident companies from establishing cross-border tax consolidations with their loss-making foreign subsidiaries while leaving their profit-making foreign subsidiaries out of the tax consolidation, *i.e.*, “cherry picking.”

Potentially, this objective could be evaded if a Danish resident company set up a permanent establishment instead of a subsidiary for loss-making activities abroad. To prevent this unintended result, the traditional principle of worldwide income taxation is partially abandoned in relation to companies that are tax resident in Denmark. Consequently, Danish companies are generally not taxed on profits and gains that are (i) realized in a foreign permanent establishment or (ii) derived from immovable property located abroad. Similarly, losses incurred from permanent establishments or foreign immovable property may not be offset against income taxable in Denmark.

An exception to the general rule that income from a permanent establishment is disregarded for Danish tax purposes is made with respect to income from a permanent



establishment which is deemed a C.F.C. entity under the C.F.C. regime. Such income remains taxable in Denmark.

Further, if an election has been made for cross-border tax consolidation, the profits and losses from foreign permanent establishments and immovable property located abroad are included in the Danish taxable income.

However, following the Danish E.C.J. case *Bevola* (C-650/16), it seems clear that Danish companies that have not opted for cross-border tax consolidation under the worldwide full consolidation principle should be able to utilize cross-border losses in permanent establishments according to the *Marks & Spencer* doctrine on final losses, despite section 8(2) of the Corporate Income Tax Act. As such, a bill has been enacted providing the opportunity to deduct losses under the *Marks & Spencer* doctrine, but under strict conditions.

Finally, income from foreign permanent establishments and foreign immovable property will be subject to taxation if the source state has relinquished its rights to tax according to a tax treaty or other international agreement.

A company has limited possibilities to offset losses allowed for carry-forward in positive income. A loss of up to DKK 9,135,000 per year (2023) and DKK 9,457,500 (2024) can always be offset against positive income, and the remaining loss can, at most, reduce the remaining income by up to 60%. It is still possible to carry forward losses indefinitely. A loss carryback is not possible.

Worldwide tax liability remains applicable for all other types of income of Danish resident companies, e.g., dividends, interest and royalties.

**“Worldwide tax liability remains applicable for all other types of income of Danish resident companies, e.g., dividends, interest and royalties.”**

## TAX RULING PRACTICE

### **Informal Ruling**

Generally, the tax authorities answer enquiries made by taxpayers or their advisers orally or in writing. However, no general rules have been laid down and the issue of informal rulings is left to the discretion of individual officials. Usually, large corporate taxpayers have a contact officer at the D.T.A. who in some cases can provide informal rulings.

No costs are involved in obtaining an informal ruling. Normally, the taxpayer can rely on an informal ruling. However, the D.T.A is not bound by informal rulings and thus a supervisory tax authority may overrule an informal ruling.

### **Binding Ruling**

Binding rulings regarding specific events may be obtained from the D.T.A. Such specific events may be either foreseen or already existing at the time the request for a binding ruling is submitted. Requests for a binding ruling are allowed, regardless of whether the enquirer is liable to taxation or not.

In 2024, a fee of DKK 400 is charged upon submission of a request for a binding ruling.

Binding rulings are normally rendered within three months, although in practice this is subject to significant deviations. Binding rulings may be appealed to the Tax Tribunal and subsequently to the ordinary court system.

The D.T.A. may refuse to issue a binding ruling if it believes that the question cannot be answered with sufficient certainty, or if valid reasons preclude a ruling being given. However, most submissions are answered by the D.T.A. A request must be submitted in writing and must contain all material information available to the applicant.

A binding ruling is valid for up to a maximum of five years.

### **Other Approval Procedures**

Prior approval may be required when a taxpayer wishes to access tax exemptions in relation to mergers, transfers of assets, demergers, or share exchanges, and thus avoid the immediate tax consequences of the disposal of the assets or shares included in such transactions.

## **PILLAR TWO**

In December 2023, the Danish Parliament passed bill no. L 5, the Minimum Taxation Act, implementing the Pillar Two rules into Danish law. The law closely follows the Council Directive (E.U.) 2022/2523 of December 14, 2022, and includes clarifications and interpretations published by the O.E.C.D. in 2022 and 2023.

Pursuant to the Minimum Taxation Act, the Income Inclusion Rule (“I.I.R.”) is applicable for years beginning on December 31, 2023, or later, whereas the Undertaxed Profits Rule (“U.T.P.R.”) will apply from income years beginning on December 31, 2024 or later. The U.T.P.R. will be applicable for years beginning on December 31, 2023, or later in situations where a constituent entity is resident in a country which does not apply the I.I.R. and the U.T.P.R. for six consecutive fiscal years beginning from December 31, 2023, in accordance with article 50 in Council Directive (E.U.) 2022/2523.

The scope of the Danish Minimum Taxation Act covers companies resident in Denmark that are part of a multinational group with a consolidated annual turnover exceeding €750 million.

The key element of Pillar Two is whether an entity that is part of an in-scope multinational group is considered low-taxed in one or more jurisdictions when the Effective Tax Rate (“E.T.R.”) is calculated to be less than 15%. The E.T.R. should be calculated on a jurisdictional level as follows:

$$\text{Adjusted Covered Taxes} \div \text{Net GloBE Income}$$

Adjusted Covered Taxes generally include all taxes imposed on income for each entity in the jurisdiction, while the Net GloBE Income is the result according to the financial accounts in the jurisdiction, with certain adjustments.

If the calculated E.T.R. falls below 15%, a so-called top-up tax should be allocated under either the I.I.R. or the U.T.P.R., unless a Qualified Domestic Top-up Tax is applied locally.

The Danish Minimum Taxation Act generally follows the Council Directive (E.U.) 2022/2523 with respect to the transition rules in Article 47-49.

# FINLAND

## Author

Jenni Parviainen  
Hannes Snellman Attorneys  
Helsinki, Finland

## GENERAL

As a Nordic welfare state with a stable economy and predictable politics, Finland is generally an attractive country for investors. The key features of the Finnish corporate taxation regime include the following:

- No minimum share capital requirement
- A low corporate income tax rate (20%)
- A participation exemption regime for dividends and capital gains
- No thin capitalization rules (however, interest deduction limitations apply)
- No withholding tax on outbound interest payments
- 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)
- An extensive network of double tax treaties and additional tax information exchange agreements

The main legal entity used is the Finnish limited liability company (“*osakeyhtiö*” or “Oy”). The Oy has both legal competence and the formal capacity to act as a party before authorities and courts, and it is a legal entity for Finnish tax purposes.

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## FINLAND’S TAX TREATIES

Finland currently has 73 double tax treaties in effect, in addition to a vast number of tax information exchange agreements.

Double tax treaties are in effect with the following jurisdictions:

|            |               |             |             |
|------------|---------------|-------------|-------------|
| Albania    | Faroe Islands | Malaysia    | South Korea |
| Argentina  | France        | Malta       | Spain       |
| Armenia    | Georgia       | Mexico      | Sri Lanka   |
| Australia  | Germany       | Moldova     | Sweden      |
| Austria    | Greece        | Montenegro  | Switzerland |
| Azerbaijan | Hong Kong     | Morocco     | Tajikistan  |
| Barbados   | Hungary       | Netherlands | Tanzania    |

|                      |            |                 |                      |
|----------------------|------------|-----------------|----------------------|
| Belarus              | Iceland    | New Zealand     | Thailand             |
| Belgium              | India      | North Macedonia | Turkey               |
| Bosnia & Herzegovina | Indonesia  | Norway          | Turkmenistan         |
| Brazil               | Ireland    | Pakistan        | Ukraine              |
| Bulgaria             | Israel     | Philippines     | United Arab Emirates |
| Canada               | Italy      | Poland          | United Kingdom       |
| China                | Japan      | Romania         | United States        |
| Croatia              | Kazakhstan | Russia          | Uruguay              |
| Cyprus               | Kosovo     | Serbia          | Uzbekistan           |
| Czech Republic       | Kyrgyzstan | Singapore       | Vietnam              |
| Denmark              | Latvia     | Slovakia        | Yugoslavia           |
| Egypt                | Lithuania  | Slovenia        | Zambia               |
| Estonia              | Luxembourg | South Africa    |                      |

Finland has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

## TAXATION OF INCOME FROM A FINNISH LIMITED LIABILITY COMPANY

### **Withholding Tax on Outbound Dividend Distributions**

Under the Finnish Withholding Tax Act, a 20% withholding tax is generally levied upon the distribution of dividends by a Finnish unlisted Oy to corporate shareholders (30% on others).

However, due to the implementation of the E.U. Parent-Subsidiary Directive (“P.S.D.”) and Finland’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 Finland, Finland may not impose withholding tax on dividends if (i) the qualified U.S. parent corporation owns shares in the Finnish Oy representing at least 80% of the voting power of all shares, and (ii) and that level of ownership has been in place for a period of at least 12 months as of the date on which entitlement to the dividends is determined. If the qualified U.S. parent corporation holds shares representing more than 10% of the voting power (with no holding period requirement), the withholding tax rate is reduced to 5% of the gross amount distributed.

Under domestic law, no withholding tax is payable where a dividend is paid by a Finnish private unlisted Oy to a foreign company corresponding to a Finnish Oy, provided that certain conditions are met. Firstly, the recipient company must be resident in the E.E.A. Secondly, either the E.U. Directive on Administrative Cooperation on mandatory automatic exchange of information in the field of taxation, or a treaty on administrative cooperation and exchange of information in tax matters within the E.E.A. shall be in effect between Finland and the country of residence of the recipient. In addition, it is required that the withholding tax cannot be fully credited in the dividend recipient’s country of residence based on a double tax treaty between Finland and the country of residence.

*“Finland generally does not impose withholding tax on outbound interest payments to foreign corporations with limited tax liability in Finland unless the loan is deemed to be an equity investment.”*

Dividends distributed to an 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 Article 2 of the P.S.D.

### **Withholding Tax on Outbound Interest Payments**

Finland generally does not impose withholding tax on outbound interest payments to foreign corporations with limited tax liability in Finland unless the loan is deemed to be an equity investment.

### **Capital Gains Taxation**

Capital gains from the disposal of shares in a Finnish Oy generally enjoy a broad tax exemption for foreign corporations with limited tax liability in Finland.

However, capital gains may be taxed in Finland if the assets of the target company mainly consist directly or indirectly of Finnish real estate. The same treatment applies if, at any time during the 365 days preceding the sale, the assets of the target company mainly consisted of Finnish real estate. The rule applies whether the target company is Finnish or foreign.

Finnish tax treaties may however provide restrictions to Finland’s right to tax the disposals.

### **Dissolution**

The dissolution of a Finnish company is generally treated as a taxable disposal of the shares by the shareholder. It is also a taxable disposal of assets for the dissolved Finnish company.

Capital gains taxation of a shareholder may be limited under the participation exemption regime, under which the disposal of fixed asset shares may be tax exempt if certain conditions are met. Where the shareholder is not a Finnish resident, Finnish domestic law or income tax treaties entered into by Finland may limit Finland’s right to tax capital gains incurred from the disposal of shares.

## **CORPORATE INCOME TAXATION OF FINNISH LIMITED LIABILITY COMPANIES**

### **General**

The net income of a Finnish company is normally subject to corporation income tax at a rate of 20%.

### **Participation Exemption for Dividend Income**

Dividends distributed between Finnish unlisted corporations are generally exempt from tax. Minimum holding requirements do not exist. Also, dividends received by a Finnish corporation from an unlisted corporation within the E.U. or the E.E.A. may benefit from a dividend participation exemption without any minimum holding requirement when the profits of the corporation distributing the dividend are subject to a tax of at least 10% tax or its corporate form is one listed in the P.S.D.



Most Finnish tax treaties provide that dividends are exempt in the hands of the recipient, provided it owns shares of stock representing at least 10% of the voting power of the company distributing the dividend.

The participation exemption is subject to several exceptions provided in the B.E.P.S. Action Plan and E.U. directives combating tax abuse.

### **Participation Exemption for Capital Gains**

For a Finnish limited liability company, shares may generally belong in one of the four asset categories: fixed assets, financing assets, investment assets (only applicable to certain specific types of companies such as insurance companies), or so-called “other assets.”

The participation exemption applies only to shares categorized as fixed assets. To benefit, the selling company must have owned at least 10% of the shares in the target company for an uninterrupted period of at least one year that has ended no more than one year before the sale, and the sale must comprise shares that have been held for the requisite period.

The participation exemption is not available to private equity investors. Further, it is not available if the target company is located in certain, mainly nontreaty countries, or if the target company is predominantly a real estate company or real estate holding company.

Losses from the sale of fixed asset shares are either nondeductible or subject to ring-fencing. Thus, if the participation exemption would apply to the sale of shares at a gain, an actual sale at a loss is nondeductible. In addition, if the shares are fixed assets but the other requirements for the participation exemption are not met, losses from the sale of those shares will be deductible only against taxable gains on fixed asset shares and only during the following five tax years.

Careful planning is recommended, as the participation exemption for capital gains is one of the most contested issues in Finnish taxation.

### **Interest Deduction Limitations**

Arm’s length interest payments are generally deductible.

However, Finland has general interest deduction limitation rules based on the Anti-Tax Avoidance Directive (“A.T.A.D.”) and B.E.P.S. Action Item 4. Interest deduction limitations apply when the net interest costs (including other lending costs) of an individual company exceed €500,000.

Under the general limitation rule, the deduction is limited to net interest expense corresponding to 25% of the company’s so-called “tax-E.B.I.T.D.” The general limitation applies to all debt. A safe harbor of €3 million applies to external net interest costs.

External loans may be deemed as related party loans if a related party’s receivable is placed as collateral for the loan, or in the case of a back-to-back arrangement. Where a loan is deemed to be a related loan, the 25% ceiling applies, and the safe harbor of €3 million is not applicable.

External net interest costs are deducted before related party net interest costs. In other words, if a company has both a bank loan and shareholders, if the bank loan



interest costs exceed 25% of the company's tax-E.B.I.T.D., any related party net interest costs (such as shareholder loan interests) are not deductible.

Denied interest deductions may be carried forward indefinitely and deducted in future years, within the deduction limitations.

Exemption may be available based on an equity escape rule, under which a company is not subject to interest deduction limitations if its equity ratio is greater than or equal to the group consolidated equity ratio (as calculated under specific regulations in Finnish domestic law restricting the application of the equity exemption. An example is a loan from a lender that holds at least a 10% interest in the borrower, whether alone or together with related parties, as such loan is regarded as equity for the purpose of calculating the group consolidated equity ratio).

Interest may not be deducted on hybrid mismatch arrangements.

### **Group Contribution Regime**

In Finland, companies within a group are not consolidated for corporate income taxation purposes. However, Finnish group companies taxable under the Finnish Business Income Tax Act may even out taxable profits and losses within the group by means of group contributions.

A group contribution is a deductible cost for the contributing company and taxable income for the recipient company, provided that the following conditions are met:

- The companies have a direct or indirect common ownership of at least 90%, which has existed for the entire tax year.
- The group contribution is recorded as income/expense in the annual statutory accounts of the companies.
- Both companies are taxed under the Finnish Business Income Tax Act. (e.g., mutual real estate companies are not covered by the Finnish Business Income Tax Act.)
- The accounting periods for both companies end on the same date.
- The amount of the group contribution does not exceed the taxable business income of the granting company.
- The group contribution is not deemed as a capital investment.

Group contributions among Finnish sister companies are allowed when a foreign mutual parent holds at least 90% of the Finnish companies, provided that (i) the foreign mutual parent is an entity comparable to a Finnish limited liability company or cooperative company, and (ii) the mutual parent is resident in the E.U. or E.E.A., or an applicable income tax treaty includes a nondiscrimination clause. Group contribution may also be available for a Finnish branch of a foreign corporation.

### **Net Operating Losses**

Net operating losses ("N.O.L.'s") from previous years may generally be carried forward for ten years, although exceptions apply.

N.O.L.'s from previous years and from the entire year of a change of ownership are generally forfeited in the case of a direct or indirect change of ownership in the loss-making company. Change of ownership is considered to occur where more than 50% of the shares in a company change ownership. If a more-than-50% change of ownership occurs in a shareholder that owns at least 20% of the shares in a loss-making entity, the shares owned in the loss-making company will be considered to have changed ownership. The rule applies to intragroup reorganizations without exception.

Dispensation from the change-in-ownership rules may be applied for from the Finnish Tax Administration. Granting a dispensation generally requires that the deduction of the N.O.L. is necessary for the continuation of the company's operations, and the N.O.L. must not be subject to "trading."

A special regime applies for N.O.L.'s to be offset against group contribution. It requires a special permit that is applied for annually. In order to utilize group contributions against N.O.L.'s after a change of ownership, 90% ownership must have been in place between the companies prior to the change of ownership resulting in the loss of the N.O.L.'s.

*"Limitations also apply regarding the amount of final loss that may be deducted, provided that deduction is allowed."*

### **Deduction for Final Losses of an E.E.A. Subsidiary**

Final losses on the liquidation of foreign subsidiaries located within the E.E.A. may give rise to a special group deduction. It applies in very restricted circumstances. Among other things, it is required that neither the subsidiary, nor another entity in the state where the subsidiary is domiciled (i) utilized the loss or (ii) is able to utilize the loss in the future.

The right to deduction is generally interpreted very strictly. Limitations also apply regarding the amount of final loss that may be deducted, provided that deduction is allowed.

## **TRANSFER TAX**

Finland has a transfer tax regime applicable to securities (including shares, options, profit participating loans) and real assets (including real estate, buildings, permanent constructions, certain land leases):

- **Real assets.** Transfer tax is payable on transfer of Finnish real assets. The buyer is liable for the transfer tax.
- **Securities with underlying real estate assets.** Upon the transfer of certain securities (as defined in the law, see above) where the underlying assets include Finnish real assets (e.g., shares in a real estate company or a real estate holding company), transfer tax is payable if the issuer is Finnish. If the issuer is foreign, transfer tax is payable if either the buyer or the seller, or both, is generally liable for tax in Finland, or a Finnish branch of certain foreign entities. The buyer is liable for the transfer tax.
- **Other securities.** Upon the transfer of other securities (e.g., shares in a "regular" business company), transfer tax is payable where the issuer is Finnish, provided that the seller or the buyer (i) is generally liable for tax in Finland or (ii) is a Finnish branch of certain foreign entities. In general, the buyer is liable

for the transfer tax. However, if the buyer is foreign, the Finnish seller has a withholding liability, unless the buyer is a Finnish branch of certain foreign entities.

As of January 1, 2024, the transfer tax is 3% on real assets and 1.5% on securities. The new tax rates are applied retroactively to transfers as of October 12, 2023.

Transfer tax is generally payable on the purchase price as well as possible other compensation as defined in Finnish law. As of 2024, the transfer tax base also includes certain loan receivables acquired in connection with the transfer of securities. Additionally, in the case of transfers of certain securities with underlying real assets, the transfer tax base includes so-called “company loans” and “construction loans.” Broadly, these are loans that are effectively allocated to shares, which is typical for certain types of Finnish real estate companies. Those loans are included in the transfer tax base when the shares to which they are allocated are transferred.



## VALUE ADDED TAXATION

Finland levies value added tax (“V.A.T.”) in line with the E.U. Directives at a standard rate of 24%. The rate will be raised to 25.5% as of September 1, 2024. Reduced rates of 10%, 14%, and 0% apply to certain supplies. Financial and insurance services as well as health services are mostly V.A.T. exempt. The reverse-charge rule is widely applicable in Finland.

The V.A.T. registration threshold of €15,000 (€20,000 as of January 1, 2025) applies to businesses that are established in Finland or that have a fixed (permanent) establishment in Finland. Group registration may be granted to taxable persons that supply exempt financial or insurance services to other taxable persons controlled by financial or insurance companies. Group members must have close “financial, economic, and administrative relationships.” Also, the one-stop-shop rules for declaration and payment of V.A.T. are applicable.

In uncertain situations, the taxpayer may request written guidance from the Finnish Tax Administration. Such guidance is non-appealable. It is also possible to apply for a preliminary ruling from the Finnish Tax Administration or the Central Tax Board.

## TRANSFER PRICING

The O.E.C.D. Transfer Pricing (“T.P.”) Guidelines are closely followed in Finland. Domestic case law has confirmed that the interpretation of the arm’s length principle should be based on the O.E.C.D. T.P. Guidelines. Furthermore, the form and content of T.P. Documentation required by Finnish law is based on the O.E.C.D. three-tiered model (Master File, Local File, Country-by-Country Report).

T.P. documentation (Master File & Local File) must be submitted to the Finnish Tax Administration only if specifically requested, and the deadline to submit is 60 days from the date of the request. Penalties for failing to comply with the submission request or submitting incomplete or erroneous documentation apply. They range up to €25,000 for each taxpayer.

The Finnish Tax Administration focus areas include business restructurings and use of intangible assets. The Finnish Tax Administration prefers to solve transfer pricing

matters in advance. Voluntary proceedings are available for taxpayers who wish to obtain advance confirmation. There are no application fees for Advance Pricing Agreement (“A.P.A.”) applications. The Mutual Agreement Procedure is generally available with tax treaty partners of Finland.

## RECENT DEVELOPMENTS

### **Global Minimum Tax**

Finland has implemented the E.U. Minimum Tax Directive (E.U. 2022/2523), which is based on O.E.C.D. GloBE model rules. The minimum tax regime applies to financial years beginning after December 31, 2023. It is anticipated that the Finnish Tax Administration will publish further practical guidance regarding the application of GloBE rules. Advance rulings in regard to GloBE rules has been ruled out at this time. Nevertheless, the Finnish Tax Administration has not expressed any intent to develop a distinctly domestic interpretation of GloBE rules or deviate from the international standard.

### **Controlled Foreign Corporations**

The purpose of the Finnish controlled foreign corporation (“C.F.C.”) rules is to prevent Finnish persons or companies from deferring or avoiding taxation by channeling transactions through a company resident in a low tax jurisdiction. If a company is deemed to be a C.F.C., a shareholder resident in Finland will be taxed directly on its share of the C.F.C.’s profits. Finnish generally accepted accounting principles and tax rules are used for these purposes. Foreign income tax paid in the foreign jurisdiction is creditable against Finnish tax.

In order for the C.F.C. rules to be applicable, the foreign corporation must be subject to low tax, meaning the actual income tax burden of the foreign corporation in its country of residence is less than three-fifths of the tax burden of a comparable Finnish corporation. To be subject to C.F.C. taxation, the controlling Finnish shareholder, either alone or together with related parties, must be entitled to at least 25% of the entity’s voting rights, capital or profits, or return on assets.

Foreign entities resident in and genuinely established in an E.E.A. country and carrying out real economic activities in that E.E.A. country are not subject to the C.F.C. rules. Further, the C.F.C. rules do not apply to foreign entities tax resident outside the E.E.A., provided that

- the entity carries out certain specific business activities as listed in the law (such as industrial production),
- the country of residence is not on the E.U. “black list” of noncooperative countries,
- Finland has a sufficient agreement on the exchange of information in tax matters with the country in question, and
- the exchange of information is also effectively carried out under the agreement.

## **B.E.P.S. and Tax Policy**

Finland is committed to implement the O.E.C.D. B.E.P.S. initiatives. It participates in the O.E.C.D. Inclusive Framework and Working Parties. Finland generally adopts and implements new B.E.P.S. developments swiftly. For example, any updates to O.E.C.D. T.P. Guidelines are applicable immediately and Finland is ready to sign the Multilateral Convention to Implement Amount A of Pillar One once the needed number of jurisdictions have joined the Convention. The aforementioned diligent approach is equally true for initiatives that have limited practical meaning for Finnish taxation but impose additional administrative burden on Finnish taxpayers, such as F.A.T.C.A. or E.U. D.A.C.6 reporting requirements.

In addition to O.E.C.D.-led work on B.E.P.S., Finland also constantly develops and maintains domestic measures to counter erosion of the tax base. These domestic measures include a comparatively restrictive debt push-down regime and a voluntary cooperative compliance program for the largest multinational enterprises having a presence in Finland. On the positive side, Finland has implemented quite attractive tax incentives. An example is the benefit of additional tax deductions for research and development activities.

*“In addition to O.E.C.D.-led work on B.E.P.S., Finland also constantly develops and maintains domestic measures to counter erosion of the tax base.”*

# AUSTRIA

## Author

Dr. Karin Spindler-Simader  
Wolf Theiss  
Vienna, Austria

## IN GENERAL

Austria does not have a specific regime applicable only to holding companies. Rather, a holding company is taxed in the same way as any other company. Nevertheless, many features of its tax system make Austria a jurisdiction worth considering for international holding companies:

- An international participation exemption exists for dividends received from foreign subsidiaries and capital gains arising from the disposition of their shares.
- A group taxation system exists that also allows cross-border loss relief.
- No formal legislation rules exist regarding thin capitalization.
- Full deductibility is provided for interest expense arising from debt incurred in connection with the acquisition of subsidiaries, subject to certain limitations.
- An extensive network of tax treaties exists, amounting to almost 90 comprehensive treaties in force and effect.
- No withholding tax is due on interest paid to nonresidents.
- No withholding tax is due on capital repayments made to nonresidents.
- The possibility to make use of the E.U. Parent-Subsidiary Directive (“P.S.D.”), the E.U. Merger Directive, and the E.U. Interest and Royalties Directive (“I.R.D.”) exists.
- The possibility of obtaining tax rulings on certain issues exists.

## CAPITALIZATION OF AUSTRIAN COMPANIES

### Equity

No taxes or stamp duties are levied on equity provided to Austrian companies.

### Debt

No taxes or stamp duties are levied on debt provided to Austrian companies.

### Thin Capitalization

Austria does not have a statutory thin capitalization rule. Loan arrangements between an Austrian company and its shareholders or affiliates are generally recognized for

tax purposes, provided that the terms of the loan meet the conditions of an arm's length test so that a third party would grant a similar loan in light of the financial situation of the company. If not, the loan capital would qualify as equity with the result that interest paid on the loan cannot be deducted as a business expense. Instead, interest payments would be treated as hidden distributions to the shareholder, triggering a withholding tax of 27.5%. In practice, debt/equity ratios of 4:1 are not uncommon.

## CORPORATE INCOME TAXATION

### **Resident Companies**

#### **Determination of Residence**

A company is resident in Austria for tax purposes if it has its legal seat and/or its place of management in Austria. The legal seat of a corporation is the place defined as such by law, by contractual agreement, or in its articles of association. The place of management of a corporation is the place where all the measures are taken that are required and essential for the management of the corporation.

#### **Tax Rate and Base**

Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 23%. Apart from corporate income tax, no other taxes or surcharges are levied on a corporation's income.

The tax base is generally the profit shown in the financial statements. Adjustments have to be made where mandatory tax provisions deviate from financial accounting rules. Profits are generally taxed on an accrual basis.

Expenses incurred in acquiring, securing, and maintaining taxable income are tax deductible. However, the following types of expenses are partly or fully nondeductible: (i) restaurant expenses, (ii) penalties and fines, (iii) income taxes, (iv) remunerations paid to supervisory board members, (v) remunerations paid to employees and managers exceeding €500,000 per person per year, and (vi) expenses in connection with earning tax-exempt income.

Deductible expenses include an investment allowance amounting to 10% of acquisition costs (up to a maximum of €1 million) of assets subject to wear and tear with a depreciation period of at least four years. The investment allowance is increased to 15% for assets pertaining to the field of ecological transformation. Goodwill, buildings, used assets, machinery that is used to extract, transport, or store fossil fuels, as well as machinery that directly uses fossil fuels, motor vehicles (except e-cars) and intangible assets (with certain exceptions), and assets that are subject to certain other beneficial tax measures are excluded from the investment allowance.

#### **Interest Expense Deduction**

In general, interest – including interest incurred in connection with the acquisition of an Austrian or non-Austrian participation – may be fully deducted from a corporation's tax base. Three restrictions regarding deductibility apply:

- First, interest incurred in connection with the acquisition of shares that were directly or indirectly purchased from a group company or from a controlling



shareholder are not deductible. Financing costs other than interest, *i.e.*, money raising costs and additional costs such as commissions incurred in connection with the acquisition of shares are generally not deductible. Examples include money raising costs, commissions, and other similar expenditures.

- Second, no deduction is possible for interest paid to a corporation if the payer and recipient are, directly or indirectly, part of the same group, or have, directly or indirectly, the same controlling shareholder, and at the level of the recipient or the beneficial owner, if different, the interest paid is (i) not subject to corporate income tax owing to a comprehensive personal or material tax exemption, (ii) subject to corporate income tax at a rate of less than 10%, (iii) subject to an effective tax rate of less than 10% owing to an applicable reduction, or (iv) subject to a tax rate of less than 10% owing to a tax refund, and here, tax refunds to the shareholder are also relevant. This provision also applies to royalties.
- Third, pursuant to the interest limitation rule, net interest expense in an assessment period is deductible only to the extent of 30% of the E.B.I.T.D.A. Net interest expense is the excess of deductible interest expense over taxable interest income in the assessment period. The E.B.I.T.D.A. equals the preliminary total amount of taxable income, *i.e.*, before applying the interest limitation rule, increased by depreciation and decreased by amortization expenses. Interest means any remuneration for the issuance of debt including all payments made to obtain the debt and any other remuneration that is economically equivalent to interest. Net interest in excess of the deductible amount in the current assessment period can be carried forward to subsequent years. The amount carried forward increases the corporation's interest expenses in the subsequent years, but not its E.B.I.T.D.A. Conversely, if 30% of E.B.I.T.D.A. exceeds the net interest expense in an assessment period ("limitation surplus"), the limitation surplus may be carried forward at the taxpayer's request, but only for the following five years.

The interest limitation rule does not apply in any of the following fact patterns:

- The corporation (i) is not fully included in consolidated financial statements, (ii) does not have an affiliated corporation, and (iii) does not have a foreign permanent establishment.
- The net interest expense of the corporation does not exceed €3 million in the assessment period.
- The corporation (i) is fully included in a group that prepares consolidated financial statements in accordance with Austrian G.A.A.P., I.F.R.S., or another comparable accounting standard and (ii) maintains an equity ratio (shareholder capital divided by assets) as of the reporting date that is either greater than the equity ratio of the group or not more than two percentage points lower than that of the group.
- The interest expense of the corporation relates to debt that is exclusively used to finance long-term public infrastructure projects of general public interest within the E.U.
- The interest expense relates to debt incurred under a binding contract concluded prior to June 17, 2016, but only through assessment periods up to and including 2025.

***“Third, pursuant to the interest limitation rule, net interest expense in an assessment period is deductible only to the extent of 30% of the E.B.I.T.D.A.”***

### Depreciation

An asset subject to wear and tear generally is depreciated on a straight-line basis over its ordinary useful life. If an asset is used for more than six months in the tax year of being placed in service or use, a full year's depreciation deduction may be claimed. Otherwise, only 50% of the yearly depreciation deduction may be claimed in that year.

Depreciation for extraordinary technical or economic loss in value is possible. For certain assets the statute mentions the depreciation rates to be used, namely buildings (generally 2.50% per annum), goodwill (6.67% per annum), and automobiles (12.50% per annum). Assets having an acquisition cost of no more than €1,000 can be fully depreciated in the year of purchase.

Taxpayers have the option to use the declining balance depreciation method, applicable to the residual book value at a constant rate of not more than 30% of the declining balance. In this way, the depreciation deduction will be front-loaded.

- It is possible to choose different depreciation methods (*i.e.*, straight-line or declining balance) for different assets.
- Transitioning from the declining balance depreciation method to the straight-line depreciation method is allowed, but only at the beginning of a fiscal year. In this case, straight-line depreciation is to be based on the remaining book value and the remaining useful life of the individual asset at the time of the transition. Transitioning from straight-line to declining balance depreciation is not possible.
- Goodwill, buildings, motor vehicles (certain exceptions apply), intangible assets (certain exceptions apply), used assets and machinery that are used to extract, transport, or store fossil fuels, as well as machinery that directly uses fossil fuels, are excluded from the option for the declining balance method of depreciation.

For buildings acquired after June 30, 2020, taxpayers are entitled to an accelerated form of straight-line depreciation. For the first year in which depreciation is claimed, the depreciation deduction is 300% of the straight-line amount and in the second year, the depreciation is 200% of the straight-line amount. The half-year depreciation rule for assets put into operation during the second half of a year does not apply.

The statutory depreciation rate generally corresponds to (i) 2.5% for buildings held in the context of an active trade or business and (ii) 1.5% for buildings held in the context of an active trade or business, but leased out for residential purposes. Thus, this leads to a maximum depreciation rate of 7.5%.

### Provision of Reserves

Only the following reserve provisions are deductible on a current basis: (i) provisions for severance payments, (ii) provisions for pension payments, (iii) provisions for other contingent liabilities, and (iv) provisions for anticipated losses from pending transactions.

### Net Operating Loss Carryover

Tax losses may be carried forward from past years to reduce the current year's corporate income tax base. The carryforward that may be claimed in any year is limited to 75% of the income of that year. No time limit applies after which the loss cannot be further deducted. In general, carryback of losses is not permitted.

A corporation's tax loss carryforwards are forfeited upon an ownership change if there is additionally a material change in its organizational (e.g., replacement of all directors of the corporation), economic (e.g., a new area of business is pursued by the corporation) and shareholder structure (e.g., the majority of shareholders of the corporation are replaced).

Irrespective of taxable income, a minimum tax is levied. It amounts to €500 per annum for limited liability companies and flexible companies (a new form of company introduced as of 2024) and to €3,500 per annum for stock companies, except that a special minimum tax of €5,452 applies to banks and insurance companies. Minimum tax payments made can be offset against future corporate income tax assessed without any limitations.

### Research and Development

As a special incentive, companies conducting qualified research and development activities may claim a credit (over and above the full deduction of the expense) equal to 14% of eligible expenses.

### Tax Year

The tax year is generally the calendar year. Corporations may apply to the tax authorities for permission to use a different tax year if reasons other than tax considerations exist for the application.

### Tax Filing and Tax Payment

In most cases, corporate income tax returns must be filed electronically by June 30 of the year following the close of the tax year. Taxpayers being represented by tax advisers benefit from longer deadlines. An extension of the filing date is possible in justified cases. Failure to file generally triggers a penalty.

Quarterly prepayments of corporate income tax are due on February 15, May 15, August 15, and November 15. Such prepayments are credited against the final amount of tax assessed. Any balance is payable within one month after receipt of the tax assessment notice.

## **Nonresident Companies**

### Definition

A nonresident company is a company having its legal seat and place of management outside of Austria.

### Tax Base

A nonresident company is taxable on business profits to the extent it carries on a business through a permanent establishment or a permanent representative in

Austria. Income and capital gains from Austrian real estate are also taxable as business profits 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 or royalties stemming from intellectual property registered in an Austrian register or used in Austria.

## **Participation Exemption**

### **Domestic Participation**

Under the national participation exemption, dividends which an Austrian resident company receives through a direct or indirect participation in an Austrian subsidiary are exempt from Austrian corporate income tax, regardless of the extent of the participation and regardless of the length of time during which the participation in the subsidiary has been held by the parent. This exemption does not apply to capital gains.

### **International Qualified Participation**

Under the international qualified participation exemption, dividends which an Austrian company receives through a direct or indirect participation in a foreign subsidiary that is an E.U. company listed in Article 2 of the P.S.D. or an entity comparable to an Austrian corporation are exempt from Austrian corporate income tax. The parent must hold a participation of at least 10% of the stated share capital of the subsidiary for a minimum duration of one year. The exemption is not applicable if the payment received is deductible abroad.

The international qualified participation exemption applies to capital gains and capital losses realized on the disposal or writing down of shares to a lower fair market value. Hence, capital gains are not taxable and capital losses are not tax deductible in connection with a sale or write-down of shares. However, final capital losses resulting from the liquidation or insolvency of a non-Austrian subsidiary remain tax deductible to the extent they exceed the amount of any tax-exempt dividends received during the last five business years.

As an alternative to tax neutrality, the Austrian parent company may opt for treating all capital gains and capital losses in connection with a sale or write-down of shares as tax effective. In such cases, capital gains are taxable, while capital losses are tax deductible, but the deductible loss is spread over a period of seven years. No deduction is allowed for capital losses that were directly caused by the prior distribution of profits.

The option for tax effectiveness may be exercised separately for each participation in the corporate income tax return filed for the year in which the participation is acquired. Once the option has been exercised, it cannot be withdrawn.

### **International Portfolio Participation**

Under the international portfolio participation exemption, dividends are exempt from tax when received by an Austrian company through a direct or indirect participation in a foreign subsidiary. The subsidiary must be an E.U. company listed in Article 2 of the P.S.D. or an entity that is comparable to an Austrian corporation. In the latter case, the entity must be resident in a state with which Austria has an agreement for



the comprehensive exchange of tax information. The exemption under the international portfolio participation rules applies when the international qualified participation rules are inapplicable. The exemption is not applicable if the payment received is deductible abroad. This exemption does not apply to capital gains.

## **Controlled Foreign Corporation (“C.F.C.”) Rules**

### **Prerequisites**

Under the Austrian C.F.C. rules, passive income of a foreign low-taxed subsidiary will be included in the tax base of the controlling corporation under certain circumstances.

Passive income encompasses the following types of income:

- Interest or any other income generated by financial assets
- Royalties or any other income generated from intellectual property
- Dividends and income from the disposal of shares, insofar as these would be taxable at the level of the controlling corporation
- Income from financial leasing
- Income from insurance, banking and other financial activities
- Income from invoicing companies that earn sales and services income from goods and services purchased from, and sold to, associated enterprises and that add no or little economic value

A foreign company is low-taxed if its effective foreign tax rate is not more than 12.5%. In order to determine the effective foreign tax rate, the foreign company's income is to be calculated in line with Austrian tax rules and the foreign tax actually paid is divided by the income computed in that manner.

Low taxation is additionally presumed if a foreign company is resident in one of the non-E.U. jurisdictions classified as noncooperative jurisdictions as of the closing date of its respective financial year. The E.U. list of noncooperative jurisdictions as of February 20, 2024 includes American Samoa, Anguilla, Antigua & Barbuda, Fiji, Guam, Palau, Panama, Russia, Samoa, Trinidad & Tobago, the U.S. Virgin Islands, and Vanuatu.

The C.F.C. rules apply if the following facts are present:

- The passive income of the C.F.C. exceeds a third of its total income. For this purpose, the income is to be calculated in line with Austrian tax provisions, except that tax-exempt dividends and capital gains are taken into account when calculating the total income of the foreign corporation.
- The controlling corporation – alone or together with its associated enterprises – holds a direct or indirect participation of more than 50% of the voting rights or owns directly or indirectly more than 50% of the capital or is entitled to receive more than 50% of the profits of the foreign corporation.

- The foreign corporation does not carry out a substantive economic activity supported by staff, equipment, assets and premises. For this purpose, the burden of proof is on the controlling corporation.

The C.F.C. rules are not applicable to foreign financial institutions if not more than one third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

For purposes of the C.F.C. rules, an associated enterprise exists if

- the controlling corporation holds directly or indirectly a participation in terms of voting rights or capital ownership of at least 25% in an entity or is entitled to receive at least 25% of the profits of that entity, or
- a legal person or individual or group of persons directly or indirectly holds a participation in terms of voting rights or capital ownership of at least 25% or is entitled to receive at least 25% of the profits of the corporation.

If a legal person or individual or group of persons holds directly or indirectly a participation of at least 25% in the corporation and one or more other entities, all the entities are regarded as associated enterprises.

The C.F.C. rules also apply to Austrian corporations having their place of management outside of Austria and to foreign permanent establishments, even if an applicable double tax treaty provides for a tax exemption in Austria.

#### Consequences of C.F.C. Status

When the C.F.C. provisions apply to a foreign corporation, the amount of the C.F.C.'s passive income that is included in the tax base of the controlling corporation is calculated in proportion to the direct or indirect participation in the nominal capital of the C.F.C. If the profit entitlement deviates from the participation in the nominal capital, then the profit entitlement ratio is decisive. The passive income of the C.F.C. is included in the financial year of the controlling corporation in which the C.F.C.'s financial year ends. Losses of the controlled foreign company are not included.

In order to prevent double taxation, the following rules apply:

- A C.F.C.'s passive income is not included in the tax base of a controlling corporation that holds only an indirect participation in the C.F.C. where such passive income is already included in the tax base of an Austrian controlling corporation holding a direct participation in the controlled foreign company.
- If the controlling corporation disposes of its participation in the C.F.C., any capital gains are tax exempt insofar as these have previously been included in the controlling corporation's tax base.
- When including the C.F.C.'s passive income in the controlling corporation's tax base, a foreign tax credit is allowed for (i) the corporate income tax imposed on the C.F.C. with regard to its passive income and (ii) the corporate income tax imposed on the C.F.C. in connection with the passive income of a lower-tier subsidiary. Foreign tax credits are allowed upon the making of an application to the Austrian tax authorities.

- If the foreign tax to be credited exceeds the controlling corporation's Austrian corporate income tax, tax credits can upon application also be claimed in the following years.

### **Switch-Over Rule Regarding Participations**

Where applicable, the switch-over rule turns off the exemptions for dividends and capital gains. The switch-over rule applies to two of the categories of participations discussed above in **Participation Exemption**. When the switch-over rule applies, the dividends and capital gains are taxable, and a foreign tax credit is given for the underlying taxes of the foreign subsidiary on dividends.

The switch-over rules apply if the predominant focus of a low-taxed foreign corporation is earning passive income. The participation categories that are affected are: (i) participations falling under the international qualified participation exemption and (ii) participations of at least 5% falling under the international portfolio participation exemption.

The switch-over rule does not apply if passive income has been taken into account under the C.F.C. provision mentioned above. Also, it is not applicable to foreign financial institutions if not more than one third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

### **Group Taxation**

#### **Prerequisites**

Austrian tax law allows group taxation for affiliated companies. Affiliated companies are those that are connected through direct or indirect participation of more than 50% of the nominal capital and voting rights. This participation must exist throughout the entire fiscal year of the member of the tax group. The conclusion of a profit and loss transfer agreement is not necessary for the purpose of setting up a tax group. Whether the companies in a group earn active or passive income is irrelevant. Thus, pure holding companies are not precluded from participating in a tax group.

The top-tier company in a tax group may be any of the following entities:

- A resident company
- A nonresident company that is an E.U. company listed in Article 2 of the P.S.D. with a permanent establishment in Austria that is registered in the commercial register with the required participations being attributable to such permanent establishment
- A company with its place of management in the E.E.A. that is comparable to an Austrian corporation with a permanent establishment in Austria that is registered in the commercial register with the required participations being attributable to such permanent establishment
- A consortium consisting of two or more companies as specified above, whether structured on a company law basis or on a purely contractual basis, provided that one consortium partner has a participation of at least 40% and each of the other consortium partners has a participation of at least 15%

*“The switch-over rules apply if the predominant focus of a low-taxed foreign corporation is earning passive income.”*

Members of a tax group may be (i) resident companies and (ii) nonresident companies that are legally comparable to an Austrian corporation. In the latter case, the nonresident company must be resident in another E.U. Member State or a state with which Austria has an agreement for the comprehensive exchange of tax information and exclusively held by resident members of the tax group or the top-tier company of the tax group.

A tax group is not formed automatically. Rather, an application must be submitted to the tax authorities by the group parent. The application must be executed by the management boards of (i) the group parent and (ii) all Austrian group members. The tax authorities then render a binding decision on whether the prerequisites necessary for establishing a tax group have been fulfilled. A tax group must have a minimum duration of three years.

The application for group taxation must contain a declaration stating that an agreement has been concluded between the Austrian-resident affiliated companies regarding the compensation of group members for corporate income taxes paid or not paid as a result of establishing the tax group. It is not necessary to set out the details of the agreement in the application. The application must disclose the respective voting and the participation rights held as well as the financial years of all the companies that wish to participate in the group.

### Consequences

The setting up of a tax group results in 100% of the taxable income of each Austrian-resident member of the group being attributed to the top-tier company in the tax group. The income of each group member is calculated on a company-by-company basis and attributed to the group parent company. Thus, in contrast to a consolidation, income resulting from intragroup transactions is not eliminated for the purpose of calculating group income. The setting up of a tax group in no way affects the way profits of the group companies are reported under financial accounting rules.

The fiscal year for all members of the group need not align. Rather, the fiscal years of all members that end in or with the fiscal year of the group parent are reported by the group parent in the manner described above.

In the case of a tax group formed by a consortium, 100% of the taxable income of each member of the group is attributed to the consortium partners on a *pro rata* basis.

When nonresident companies are members of a tax group, only their losses are attributed on a *pro rata* basis to the top-tier company. Thus, the losses of non-Austrian subsidiaries can be utilized in Austria even though, under general principles, their profits are taxable only in the respective foreign countries. The losses of nonresident group members must be computed in accordance with Austrian tax rules. Nonetheless, these losses cannot exceed the amount calculated pursuant to tax rules in the country of residence of the foreign member.

The aggregate losses of nonresident companies are subject to a ceiling that is similar to the rule for the carryforward of losses. The ceiling is 75% of the income of the top-tier Austrian company in a tax group and the Austrian-resident members.

Losses of nonresident companies that have been deducted by a tax group in Austria are recaptured in Austria to the extent the non-Austrian subsidiary utilizes or may



utilize the losses abroad or drops out of the tax group. In the case of final capital losses resulting from a liquidation or insolvency, the recapture is reduced by non-deductible impairments (see below).

Group member tax loss carry forwards resulting from taxable years ending before the tax group was established and tax loss carry forwards assumed by group members pursuant to a restructuring can be applied only against profits generated by the respective group member, up to 100%. On the other hand, tax loss carry forwards of the top-tier company in a tax group can be applied against such company's own profits and also against the profits of group members.

No deductions are allowed for impairments in value of participations in companies that are part of a tax group.

### **Transfer Pricing**

Pursuant to the case law of the Austrian Supreme Administrative Court, agreements between related parties (such as a parent company and its subsidiary) are recognized for tax purposes only under the following conditions:

- The agreements have been concluded in writing.
- Their content is unambiguous.
- They have been concluded in accordance with the arm's-length principle (*i.e.*, on terms that would be agreed by unrelated parties). The Austrian tax authorities follow the O.E.C.D. Transfer Pricing Guidelines in this respect.

Pursuant to the Austrian Transfer Pricing Documentation Act, multinational groups with consolidated group revenues of at least €750 million in the preceding fiscal year are required to prepare a Country-by-Country Report, which Austria will automatically exchange with other countries. Additionally, a separate business unit that is tax-resident in Austria and reports revenues of at least €50 million in the two preceding fiscal years of a multinational group must prepare transfer pricing documentation in the form of a master file and a local file.

*“No deductions are allowed for impairments in value of participations in companies that are part of a tax group.”*

## **WITHHOLDING TAX ON OUTBOUND PAYMENTS**

### **Dividends**

#### **P.S.D.**

Dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 27.5%. The rate may be reduced to 23% in case of corporate shareholders. However, dividends paid by an Austrian company to an E.U.-resident parent company are exempt from taxation under legislation implementing the P.S.D. where the parent company directly or indirectly 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.

### Potentially Abusive Structure

In addition, tax must be withheld in cases of suspected abuse. In particular, abuse is assumed if the parent company is not engaged in an active trade or business, does not have its own employees, and does not have its own premises. In such cases, withheld tax is refunded on application of the parent company provided that the abuse presumption can be rebutted.

### Treaties

Under most tax treaties, withholding tax is reduced to 15% for portfolio dividends and 5% for qualifying dividends. In some cases, withholding tax may be eliminated entirely. Austria has concluded more than 90 income tax treaties, 89 of which are currently in effect, including those contained in the following table:

|                      |               |                     |                      |
|----------------------|---------------|---------------------|----------------------|
| Albania              | Finland       | Macedonia           | Slovakia             |
| Algeria              | France        | Malaysia            | Slovenia             |
| Armenia              | Georgia       | Malta               | South Africa         |
| Australia            | Germany       | Mexico              | South Korea          |
| Azerbaijan           | Greece        | Moldova             | Spain                |
| Bahrain              | Hong Kong     | Mongolia            | Sweden               |
| Barbados             | Hungary       | Montenegro          | Switzerland          |
| Belarus              | Iceland       | Morocco             | Taiwan               |
| Belgium              | India         | Nepal               | Tajikistan           |
| Belize               | Indonesia     | Netherlands         | Thailand             |
| Bosnia & Herzegovina | Iran          | New Zealand         | Tunisia              |
| Brazil               | Ireland       | Norway              | Turkey               |
| Bulgaria             | Israel        | Pakistan            | Turkmenistan         |
| Canada               | Italy         | Philippines         | Ukraine              |
| Chile                | Japan         | Poland              | United Arab Emirates |
| China                | Kazakhstan    | Portugal            | United Kingdom       |
| Croatia              | Kosovo        | Qatar               | United States        |
| Cuba                 | Kuwait        | Romania             | Uzbekistan           |
| Cyprus               | Kyrgyzstan    | Russia <sup>1</sup> | Venezuela            |
| Czech Republic       | Latvia        | San Marino          | Vietnam              |
| Denmark              | Liechtenstein | Saudi Arabia        |                      |
| Egypt                | Lithuania     | Serbia              |                      |
| Estonia              | Luxembourg    | Singapore           |                      |



### Repayment of Capital

In contrast to dividends from profits, the repayment of capital – whether resulting from a formal capital reduction or from the distribution of capital reserves – does not trigger withholding tax under Austrian domestic law. Such repayment of capital reduces the tax basis of the shares held by the recipient of the dividend. This may become relevant in the case of a later sale of the shares as the capital gain will be

<sup>1</sup> This treaty has been partially suspended.

increased because of the reduction in basis. Austrian companies must keep a capital account for tax purposes to document the amount distributable as a repayment of capital.

### **Capital Gains**

A nonresident shareholder is 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 at any point in time during the preceding five calendar years. If the participation does not exceed this threshold, capital gains are not taxable. For corporate shareholders, corporate income tax is levied at the regular rate of 23%. The tax is levied by way of assessment rather than by way of withholding.

However, Austria follows the O.E.C.D. Model Convention and generally has ceded its right to tax capital gains from the disposal of shares to the country of residence of the shareholder in most of its tax treaties. Only in case of “real property-rich” companies does Austria retain its right to tax.<sup>2</sup>

### **Royalties**

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%. Expenses do not reduce the tax base, thereby resulting in gross basis taxation. If the recipient of the royalties is resident in an E.U. or E.E.A. Member State, expenses directly connected to the royalty income may be deducted from the withholding tax base, resulting in net basis taxation. In this case, the withholding tax rate is increased to 25%.

No withholding tax applies within the scope of the I.R.D. Austria exempts intragroup royalty payments from withholding tax if (a) the payor is a resident company or a permanent establishment of a company that is resident in another Member State of the E.U. and (b) the beneficial owner of the royalties is an associated company that is resident in another Member State of the E.U. or a permanent establishment situated in another Member State of the E.U. of an associated company that, itself, is resident in another Member State of the E.U.

For purposes of applying these provisions, a company is an associated company of a second company if any of the following conditions are met:

- The first company has a direct holding of 25% or more in the capital of the second company.
- The second company has a direct holding of 25% or more in the capital of the first company.
- A third company has a direct holding of 25% or more in the capital of the first and second company.

The I.R.D. treatment is supplemented by the royalty provisions of Austria’s income tax treaties. Under most tax treaties, the withholding tax is reduced or eliminated.

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<sup>2</sup> O.E.C.D., Model Tax Convention on Income and on Capital, paragraph 4 of article 13.

### **Interest**

Interest payments on loans (not on bonds) to nonresident corporations are not subject to Austrian withholding tax.

### **Other Income**

A 20% withholding tax is levied on the following types of income earned by nonresidents of Austria:

- Remunerations in connection with an occupation as an author, lecturer, artist, architect, sportsperson, or performer in Austria
- Payments for a right of use regarding works protected by copyrights or industrial property rights
- Supervisory board remunerations
- Payments for commercial or technical consulting work

However, in many of these cases Austria waives its taxing rights under provisions of various tax treaties.

## **OTHER TAX ISSUES**

### **Wealth Tax**

Austria does not currently impose a general wealth tax on companies or individuals. The only wealth tax currently imposed is an annual tax on Austrian real estate levied by Austrian municipalities.

### **Value Added Tax**

Austria levies value added tax in line with the pertinent E.U. Directives at a standard rate of 20%. Reduced rates of 10% and 13% apply to certain supplies. A number of exemptions are applicable. Examples include financial services and health services for which no V.A.T. is imposed.

### **Real Estate Transfer Tax**

The transfer of Austrian real estate triggers real estate transfer tax. In the case of a sale of Austrian real estate the tax base is generally the purchase price, and the tax rate amounts to 3.5%. In addition, a 1.1% court registration fee is assessed, based on the fair market value of the property transferred.

Real estate transfer tax at a rate of 0.5% of the property value of the real estate is triggered if Austrian real estate is part of the assets of a corporation or a partnership, and at least 95% of the shares in the corporation or the interests in the partnership are transferred or pooled in the hand of a single buyer or in the hand of a tax group. The same applies in the case of a partnership holding Austrian real estate if at least 95% of the interests in the partnership are transferred to new partners within a period of five years.

## **Stamp Duty**

Austria levies stamp duties on a wide range of legal transactions, including assignment agreements, lease agreements, and surety agreements, if a written deed evidencing such stamp-dutiable transaction is signed and a certain Austrian nexus exists. However, these stamp duties can be avoided in many cases by way of careful structuring.

## **Tax Rulings**

A legally binding formal tax ruling procedure exists in connection with questions concerning restructurings, tax groups, international tax law, value added taxation and the existence of abuse of law. If certain formal prerequisites are met, the competent tax office must issue a tax ruling, generally within a period of two months from filing of the application. The ruling must contain the facts and statutory provisions on which it is based, a legal evaluation of the facts, and the time frame during which it is valid. In addition, the applicant may be required to report on whether the facts of the case have been implemented and also on whether the implemented facts are different from those outlined in the request. A fee is due in conjunction with any such request. The fee ranges between €1,500 and €20,000, depending on the applicant's annual turnover,



## **The General Anti-Avoidance Rule (“G.A.A.R.”)**

Taxpayers are free to arrange their economic affairs in the manner they deem most beneficial, which includes choosing those structures and approaches that incur the least tax cost. Nevertheless, Austrian tax law contains a G.A.A.R. provision that restricts overly aggressive tax planning. Pursuant to this provision, the tax liability cannot be avoided by abusing legal forms and methods available under civil law. If such an abuse has been established, the tax authorities may compute the tax as it would have been had a genuine legal arrangement been carried out.

Abuse is defined as a legal arrangement consisting of one or multiple steps, or a series of legal arrangements, that is not genuine in light of the commercial objective. Arrangements are not genuine when they do not make sense except for the tax-saving effect, because the main purpose or one of the main purposes is to obtain a tax advantage that defeats the object or purpose of the applicable tax law. In principle, no abuse exists if valid commercial reasons exist that reflect economic reality.

## **Notification Obligation Regarding Reportable Cross-Border Arrangements**

Under the Austrian implementation of D.A.C. 6, intermediaries must file information on reportable cross-border arrangements, that is within their knowledge, possession, or control, with the Austrian Minister of Finance generally within 30 days.

Certain arrangements are unconditionally notifiable, while other arrangements are conditionally notifiable where it can be established that the main benefit or one of the main benefits which a person may reasonably expect to derive from the arrangement, having regard to all relevant facts and circumstances, is the obtaining of a tax advantage. In general, the list of hallmarks closely follows D.A.C. 6.

Intermediaries are granted the right to a waiver from filing information on a reportable cross-border arrangement where the reporting obligation would breach the

legal professional privilege under Austrian law, unless the intermediary is released from the obligation to secrecy.

### **Hybrid Mismatch Rules**

Austrian corporations are subject to complex hybrid mismatch rules under the Austrian domestic provisions implementing A.T.A.D. 1 and A.T.A.D. 2. These provisions apply in case of the deduction of an expense without inclusion (“D/NI”) or of a double deduction of an expense (“DD”) and for reverse hybrid entities.

- In a D/NI case involving a payment by an Austrian resident, the deduction is denied in Austria if the payment is not taxed abroad. Where the payment is made by a foreign hybrid entity and the deduction is not denied abroad, the earnings are taken into account for tax purposes at the level of the Austrian corporation. In a fact pattern involving a foreign disregarded permanent establishment having income that is neither included in Austria nor in the permanent establishment state, the income is included in Austria.
- In a DD case, the deduction is denied in Austria at the level of the corporation making the payment. Where the deduction involves a payment by an Austrian hybrid entity or an Austrian permanent establishment and the deduction is not denied abroad, the deduction is denied in Austria. In case of a dual resident corporation, the deduction is denied in Austria, unless the corporation is deemed to be solely a resident of Austria under the terms of an income tax treaty concluded with an E.U. Member State. However, deductions may be claimed when the income of the dual resident corporation is subject to tax in the current period or will be in subsequent tax periods.
- Income of a nonresident controlling corporation in a reverse hybrid entity is taxable in Austria if it is not taxed in any other country, regardless of any tax treaty. A reverse hybrid entity is an Austrian partnership that is considered a taxable person under foreign tax law. A nonresident controlling corporation – alone or together with its nonresident associated enterprises – holds, owns, or is entitled to receive, directly or indirectly, a participation of more than 50% of the voting rights, more than 50% of the capital, or more than 50% of the profits of the reverse hybrid entity.

### **Foreign Tax Credit**

Pursuant to a decree issued by the Austrian Ministry of Finance, certain items of foreign-source income are exempt from Austrian taxation, including: (i) income from immovable property located in a foreign state, (ii) business income attributable to a foreign permanent establishment, and (iii) income derived from building sites or construction or installation projects. The decree applies if all the following requirements are met:

- The Austrian taxpayer derives the relevant income from a country with which Austria has not concluded a tax treaty.
- The foreign jurisdiction imposes a tax on the income that is comparable to Austrian income or corporate income taxation.
- The average foreign tax rate computed in accordance with Austrian tax principles exceeds 15%.

*“Austrian corporations are subject to complex hybrid mismatch rules under the Austrian domestic provisions implementing A.T.A.D. 1 and A.T.A.D. 2.”*

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 to income from sources within the relevant foreign country. No other “basket” rules based on the character of the income exist when computing the allowable foreign tax credit.

Where a tax treaty applies the credit method to foreign-source income, but does not cover local taxes, such local taxes may then be credited against Austrian tax under Austrian domestic law.

Application of the exemption method or the credit method pursuant to the decree requires the taxpayer to maintain proper documentation listing all of the following items:

- The foreign jurisdiction
- The type of income
- The amount of income
- The average foreign tax rate
- The amount of creditable tax where the credit method applies
- The relevant accounting period

## MINIMUM TAX (PILLAR TWO)

Beginning with 2024, Austrian corporations and permanent establishments are subject to a minimum tax in accordance with the E.U. Pillar Two Directive. The Minimum Taxation Act applies to both domestic and multinational corporate groups with consolidated annual revenues exceeding €750 million in at least two of the four preceding fiscal years. It follows that all Austrian business units, whether within domestic or foreign groups, face a minimum effective tax rate of 15%.

Certain exemptions specifically apply to entities such as public entities and investment funds. Additionally, *de minimis* provisions exist for smaller corporate groups generating less than €10 million in minimum tax revenue and €1 million in minimum tax net profit, averaged over the current and two preceding fiscal years. Various safe harbor rules apply, such as the N.E.S. safe harbor and the N.M.C.E. safe harbor, which lead to zero supplementary tax.

Three forms of tax levies are introduced by the law: the national supplementary tax (“N.E.S.”), the primary supplementary tax (“P.E.S.”), and the secondary supplementary tax (“S.E.S.”). The N.E.S., which is fully levied irrespective of the shareholding proportions within Austria, serves as the initial step in tax collection. The N.E.S. ensures that corporate groups are subject to minimum taxation on their domestic profits if the level of taxation in Austria is below the minimum tax rate. If the N.E.S. is insufficient, the P.E.S. and S.E.S. act as additional mechanisms to ensure the minimum tax threshold is met, primarily at the level of the ultimate parent company. The P.E.S. is intended to levy the share of the supplementary tax amount of a foreign business unit attributable to a domestic parent company in Austria. The S.E.S. is intended to serve as a catch-all rule for the P.E.S. by levying the portion of the total

amount of S.E.S. of a multinational group of companies attributable to Austria that was not levied by way of a P.E.S. in Austria.

Tax obligations are calculated using a jurisdictional blending approach, meaning all business units within Austria are collectively considered to assess under-taxation. The effective tax rate is determined by comparing the adjusted recognized taxes to the minimum tax net profit within the tax jurisdiction. If this rate falls below 15%, a supplementary tax is calculated to cover the shortfall.

Procedural rules oblige each business unit in Austria to submit a minimum tax report, though centralization options are available to simplify compliance. Penalties for non-compliance include fines up to €100,000.



## FRANCE

**Author**  
Michel Collet  
CMS-Francis Lefebvre  
Avocats  
Paris, France

### CORPORATION INCOME TAX – GENERAL

The standard corporation income tax (“C.I.T.”) rate in France for fiscal years beginning in 2023 is 25%. Lower rates apply to small- and medium-sized enterprises (“S.M.E.’s”).

In addition, companies with gross income exceeding €7,630,000 and incurring C.I.T. in excess of €763,000 are liable for the social contribution of 3.3% on the C.I.T. due. The effective tax rate on the excess is 25.825%.

The 2023 Finance Bill introduced a temporary solidarity contribution for the oil, gas, coal, and refinery industry.<sup>1</sup> The tax applied to companies or permanent establishments carrying on business in France, or having a portion of their profits taxed in France under a tax treaty, where at least 75% of sales for the first financial year beginning on or after January 1, 2022, are derived from economic activities in the crude oil, natural gas, coal, and refining industries. This contribution has not been renewed by the 2024 Finance Bill.

The tax base was the excess of the taxable income for the first financial year beginning on or after January 1, 2022, over a base that is equal to 120% of the average amount of taxable income for the four immediately preceding financial years. The contribution rate was set at 33% of the excess. The contribution was not deductible in determining taxable income.

With a tax group, the contribution was determined company by company on an individual basis.

### NET OPERATING LOSSES

#### **Carryforward**

Net operating losses (“N.O.L.’s”) can be carried forward with no time limit. However, the amount that is offset against the taxable result cannot exceed €1 million plus 50% of the amount of taxable income in the carryforward year that exceeds €1 million. The tax authorities, when auditing the year in which the N.O.L.’s. are claimed as a setoff, may examine the operations that generated the N.O.L.’s. even if the operations took place in fiscal year that is statutory barred.

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<sup>1</sup> Law no. 2022-1726, December 30, 2022 transposing Council Regulation (E.U.) 2022/1854 of October 6, 2022 on an emergency intervention to address high energy prices.

## **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 2024 can be carried back only to reduce taxable income in 2023. The carryback is capped at €1 million. The carryback does not generate a refund of tax. Rather, it gives rise to a tax credit. This tax credit can be (i) refunded at the end of the five-year period following the year during which the loss is incurred, (ii) used before that date for the payment of the C.I.T. (including the payment of C.I.T. installments), or (iii) offered as a guaranty to a credit institution.

## **TAX CONSOLIDATION**

### **Scope and Conditions**

Under §223A *et seq.* of the F.T.C., a consolidated tax return may be filed by a French company or a French branch of a foreign company that holds, directly or indirectly through other French consolidated companies or, subject to certain conditions, through an E.U.-resident company,<sup>2</sup> at least 95% of the capital and voting rights of other French companies or branches of foreign companies.

The following conditions must be met in order to file a consolidated tax return:

- All members of the tax-consolidated group are subject to French C.I.T. and have the same financial year.
- Another French company that is subject to C.I.T. does not hold 95% or more of the consolidating company, either directly or indirectly.<sup>3</sup>
- The parent company satisfies the 95% minimum holding, directly or indirectly, throughout the entire financial year.
- Adequate tax group elections have been filed in a timely manner.<sup>4</sup>

The French tax consolidation regime has been modified to reflect a favorable ruling in the *Papillon* case.<sup>5</sup> The European Court of Justice (“E.C.J.”) held that a consolidated group may include French subsidiaries indirectly held through a company or permanent establishment that is (i) resident in the E.U. or E.E.A.<sup>6</sup> and (ii) subject to C.I.T. without exemption in its country of residence.

Pursuant to case law of the E.C.J.,<sup>7</sup> the Amended Finance Law for 2014 allowed the so-called “horizontal tax consolidation” of French sister companies and their

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<sup>2</sup> Or companies situated in Norway, Iceland, or Liechtenstein.

<sup>3</sup> A French company subject to C.I.T. may indirectly hold a 95% participation in the consolidating company, provided 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%.

<sup>4</sup> The filing deadline matches the deadline for filing C.I.T. annual returns.

<sup>5</sup> *Société Papillon v. Ministère du Budget, des Comptes Publics et de la Fonction Publique*, Case C-418/07, [2008] E.C.R. I-08947.

<sup>6</sup> Liechtenstein, Norway, Iceland

<sup>7</sup> *SCA Group Holding and Others*, Joined Cases C-39-41/13, [2014] ECLI:EU:C:2014:1758.

subsidiaries under the conditions explained above where at least 95% of their shares are held, directly or indirectly, by the same company that is resident in the E.U. or the E.E.A. This foreign entity must be subject to C.I.T. in its country of residence and must have the same financial year-end. Where these facts exist, one of the two top sister companies may elect to be the consolidating company.

### **Computation of the Group Taxable Result**

The consolidating company is liable for C.I.T. on the group taxable income, which is the sum of all members' profits and losses, including capital gains and losses. This aggregated taxable result is subject to the following adjustments:

- Provisions for doubtful accounts and risks on other members of the consolidation are reinstated for tax purposes. Later reversal of provisions would be eliminated for tax purposes.
- Provisions for depreciation of assets acquired from other members of the consolidation are reinstated for tax purposes, up to the net capital gain that was eliminated for the computation of the group taxable income (see below). Future reversal of the provision would be tax neutral.
- Capital gains and losses on the transfer of fixed assets and shares between members of the consolidation are eliminated. They would be recaptured in case of transfer of the assets out of the consolidation, exit of the owner or the seller from the consolidation, termination of the consolidation, or contribution of the assets to a member of the consolidation.
- Conversely, the deductibility of the amortizations in the hands of the acquirer is limited to the difference between (i) the yearly depreciation calculated by the acquirer with respect to the acquisition cost in its books and (ii) the yearly depreciation calculated by the seller on the acquisition cost registered in its own books.
- Sales of goods or services occurring between group companies at a price below their fair market value but above their tax cost do not entail any adverse tax consequences.
- Distributions made between companies of the tax group are tax exempt up to 99% of their amount, provided the distributing entity is consolidated for more than one financial year at the time of the distribution.<sup>8</sup> This exemption also applies to dividends received from subsidiaries in the E.U. or E.E.A. that would have been qualified to file a consolidated return had they been located in France for tax purposes.

Several decisions of the E.C.J. have targeted the French tax consolidation regime as going beyond the mere consolidation of results. Consequently, the Finance Act for 2019 has repealed the tax elimination of income arising from several transactions occurring within the tax consolidation with effect from January 1, 2019:

- With the exception of sales of goods or services within the consolidation invoiced at cost, debt waivers and subsidies granted between members of the tax group are no longer eliminated.

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<sup>8</sup> For financial years closing on or after December 31, 2023.

- Subsidies granted before January 1, 2019 and eliminated under the former regime may become taxable at the termination of the tax group or the exit of a member involved in the transaction. This treatment applies to indirect subsidies on the transfer of fixed assets and shares through reduction of the sale price that were eliminated, and other indirect subsidies, direct subsidies, and debt waivers granted during one of the five fiscal years preceding the exit or the termination.
- The transfer of substantial shareholdings (see **C.G.T. on Company Shareholdings**) eligible for the 88% tax relief are no longer fully eliminated if they are realized after January 1, 2019. Accordingly, capital gains on substantial shareholdings are taxable at group level on 12% of the gain. The 12% taxable portion on transfer realized before January 1, 2019 and eliminated pursuant to former rules is taxable at (i) the first transfer of the shares after January 1, 2019 or (ii) at the time the owner entity exits the tax group after that date.

The above provisions may also, under certain circumstances, apply to transactions with E.U. intermediary entities (for example, an E.U. entity interposed between two French entities that are members of the consolidation) or E.U. consolidating entities (in case of so-called horizontal consolidations).

### **Specific Group Provisions**

An anti-debt-push-down provision under §223B, known as the “*Charasse Amendment*,” restricts the deduction of interest expense 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 reduce interest expense incurred to fund the acquisition for the year of the acquisition and the following eight years.<sup>9</sup>

The limitation of deductibility of net financial charges (see the discussion in **Deductibility of Interest Charges**, below) and the Intellectual Property box regime (see the discussion in **Taxation of Inbound Royalties - Industrial Property (“I.P.”) Box Regime**, below) apply at group level when group taxation has been elected.

Several provisions also aim at facilitating restructurings within the consolidation:

- Mergers between companies of the tax group can be carried out free of tax if the conditions of a reorganization regime are met.
- The acquisition or merger of the consolidating entity by a French entity that fulfills all the conditions to be the consolidating entity, itself, will not cause the tax group treatment from being terminated. Some de-grouping charges may be suffered, but several dispositions intend to mitigate these adverse tax consequences.

Tax grouping is attractive in a leveraged buyout because it combines consolidation and tax-free distributions, albeit subject to the 1% add-back.



<sup>9</sup> Interest expense disallowed under the Charasse Amendment are determined using the following formula: (interest expense of all tax group members) × (acquisition price ÷ average indebtedness of all tax group members).

## TAXATION OF TAX TRANSPARENT ENTITIES

French partnerships in the form of an S.N.C., an S.C., or an S.C.S. are tax transparent entities under French tax law. Also, tax transparent are limited partnerships of an S.C.A., but only for the shareholders having unlimited liability. Some limited liability companies such as an S.A.R.L. held by families can elect for tax transparent treatment.

Members with limited liability in a partnership are not entitled to transparent tax treatment. Consequently, profits or losses are not deemed to be realized by the partners, but by the entity even though the partnership is not subject to tax. In such case, the partners are responsible for the tax on the partnership's income on a *pro rata* basis in the capital.

In the context of foreign partnership, the legal characteristics of the foreign entity are analyzed and compared with those of a French entity. The focus is directed mostly to liability and incorporation resulting in legal personality. The analysis is used to identify the French fiscal regime applicable to the entity.<sup>10</sup> Limited partnerships are most often compared to corporations.

As an exception to the principle of translucent entities – meaning entities that qualify for treaty benefits because their shareholders qualify for those benefits – administrative guidelines state that passive income paid by French entities to foreign partnerships that are tax transparent in their own jurisdictions are deemed paid to the members of the partnership for application of French domestic law and double tax treaties.<sup>11</sup>

France has concluded several tax treaties that specifically address tax transparent entities, such as treaties with the U.S., the U.K., Switzerland, Japan, Luxembourg, and Germany.

## FOREIGN TAX CREDITS

In absence of double tax treaties, double tax relief takes the form of a deduction from income that may be claimed for a foreign tax on income that is taxable in France. Consequently, no tax credit is allowed unless a tax treaty applies.<sup>12</sup>

In presence of a double tax treaty, foreign taxes generally give rise to a foreign tax credit available against French tax on the same income. Most of the treaties provide that the foreign tax credit is limited to the tax due in France on this income, although exceptions exist, mostly in connection with African countries. The foreign tax credit in excess of the French tax or the foreign tax credit claimed by a loss-making entity is not creditable and not deductible. It cannot be refunded or carried forward. Foreign taxes levied in contradiction to the terms of an income tax treaty are deductible, only. Thus, the benefit comes in the form of a reduction in French taxable income, not a setoff against French income tax.

<sup>10</sup> *Artemis, Conseil d'Etat*, November 24, 2014, #363556.

<sup>11</sup> BOI-INT-DG-20-20-30 #120 to 140

<sup>12</sup> §39,1, 4° of the French Tax Code (“F.T.C.”).

**“Members with limited liability in a partnership are not entitled to transparent tax treatment.”**

## TAXATION OF DIVIDENDS

Dividends are included within the taxable result of corporations. However, a participation-exemption regime applies to limit the tax burden on distributions.

### **Taxation of Inbound Distribution – The Dividends Received Deduction (“D.R.D.”)**

Dividend distributions received by French corporations are subject to C.I.T., in principle. The tax residence of the company paying the dividend is not material. Under the D.R.D. regime, distributions are 95% exempt from C.I.T. where all 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 (“Qualifying Shareholding”) and is the beneficial owner of the dividends.<sup>13</sup>
- The Qualifying Shareholding must be held for at least two years.

Pursuant to several decisions of the Constitutional Court, dividends on preference shares with reduced voting rights or none at all are eligible for the exemption.<sup>14</sup>

The exemption applies from the first day of the Qualifying Shareholding, provided that the shares are held for two years. Failure to maintain the shares for two years will result in a claw-back of the exemption. A disposal of shares within the course of a tax-free reorganization is disregarded for D.R.D. purposes.

The D.R.D. regime applies to dividends and other distributions attached to the shares of stock held by the receiving corporation.

The 95% exemption under the D.R.D. is achieved by disallowing deductions for otherwise deductible expenses in an amount equal to 5% of the dividends received (1% in the Tax Consolidation regime). The disallowed amount is deemed to be costs for management of the shareholding. N.O.L.’s can be offset against that taxable amount.

The D.R.D. applies to dividends received from foreign subsidiaries without limitation, other than those conditions set forth above. The 5% add-back to the D.R.D. is calculated on the gross amount of the dividends received from the foreign subsidiary. Where the costs for management of the shareholding are lower than 5% of the dividends received, foreign tax withheld in a source country may be used as a tax credit against the C.I.T. due on the portion of the 5% add-back that is in excess of the actual costs. Foreign tax withheld in a source country may also be used as a tax credit against any French withholding tax that may be due upon the further

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<sup>13</sup> In accordance with recent French case law, Article 145 1-b of the F.T.C. has been amended to include both full ownership and bare ownership as qualifying for the 5% capital threshold.

<sup>14</sup> Cons. Const., February 3, 2016, #2015-520, QPC; Cons. Const., July 8, 2016, #2016-553 QPC.

distribution of the dividend to a foreign shareholder of the French company.<sup>15</sup> The ability to credit the withholding taxes incurred on the inbound dividend against the French withholding tax on the outbound dividend lapses after five fiscal years.

Distributions from a company established in a Noncooperative State or Territory (“N.C.S.T.”) are not eligible for the D.R.D., except where the corporate shareholder justifies that its holding reflects a valid commercial purpose and is not driven by tax fraud. The N.C.S.T. legislation is discussed in detail below in **Noncooperative States and Territories**.

In anticipation of efforts to combat base erosion and hybrid instruments, the D.R.D. is not applicable to distributions that give rise to deduction at the level of the payor company. This provision complies with the amendment of the P.S.D. on cross-border distributions within the E.U. single market. Under the amendment, the P.S.D. does not apply when a deduction is claimed by the payor company for the dividend paid.<sup>16</sup>

Since January 1, 2019, dividends distributed by subsidiaries located in a Member State of the E.U. or the E.E.A. to a French company and eligible to the D.R.D. with a 99% exemption if (i) the French company does not elect French tax consolidation<sup>17</sup> (see above discussion of tax consolidations at **Scope and Conditions**) and (ii) the company making the distribution meets all the conditions required in order to participate in the filing of a consolidated tax return in France for more than one financial year,<sup>18</sup> were they to be established in France.

The exemption is subject to the general anti-abuse rule of Article 6 of E.U. Directive 2016/1164/E.U. (“G.A.A.R.”). See Article 205 A of the F.T.C. – General C.I.T. Anti-Abuse Provision.

The G.A.A.R. tackles an arrangement or a series of arrangements that (i) have been put into place for the main purpose, or one of the main purposes, of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and (ii) are not genuine, having regard to all relevant facts and circumstances. An arrangement or a series thereof is regarded as non-genuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality.

The guidelines of the French tax authorities consider that the condition of “commercial purpose” does not necessarily exclude structures set-up for fundholding, financial or organizational purposes.

In practice, the presence of an autonomous decision-making process at the level of the holding company is generally critical in asserting the validity of its commercial

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<sup>15</sup> French Administrative Guidelines, BOI-RPPM-RCM-30-30-20-50, September 12, 2012.

<sup>16</sup> Council Directive 2014/86/E.U. amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the case of Parent Companies and Subsidiaries of Different Member States, 2014 O.J. L 219/40.

<sup>17</sup> *Manitour BF SA and Bricolage Investissement France SA*, E.C.J., May 11, 2023, no. C-407/22 and C-408/22.

<sup>18</sup> For financial years closing on or after December 31, 2023.

*“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 . . .”*

purpose. Stated differently, prudence suggests that the commercial reasons for a structure should be provided by operating management and not the tax department.

Finally, 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 transfer of legal ownership. Through the trustee (*fiduciaire*), the settlor (*constituant*) must maintain by contract all its voting and financial rights on the stock. This development allows the use of a *fiducie* for leveraged buyouts (“L.B.O.’s”) or debt restructuring and proves more flexible and less burdensome than the so-called “double Luxco structure,” which is not exempt from tax or legal challenges.<sup>19</sup>

### **Withholding Tax on Outbound Dividends**

Under §119-*bis* 2 of the F.T.C., a withholding tax is levied on outbound dividend payments at the standard rate of C.I.T. Dividend payments made to entities based in an N.C.S.T., other than those on the grey list, are subject to a withholding tax of 75%. An exception is provided where the French entity making the distribution can demonstrate that the distribution is not mainly tax driven.

In comparison, withholding is not required on dividends paid to qualifying E.U. parent companies (i) subject to a 10% ownership test (the “E.U. Directive Exemption”) or (ii) subject to a 5% ownership test (the “5% E.U. Exemption”) where the E.U. parent company is unable to recover French-source withholding tax in its residence jurisdiction. In both cases, a two-year holding requirement applies.

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.

## **TAX TREATMENT TO OUTBOUND DIVIDENDS PAID TO COMPANIES LOCATED IN 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. or E.E.A. resident, defined as having its place of management and control in another E.U. or E.E.A. Member State.
- The shareholder corporation is incorporated under one of the legal forms listed as an appendix to the E.U. Directive 2011/96/E.U. dated November 30, 2011.
- The shareholder corporation is the beneficial owner of the dividends distributed.

<sup>19</sup> Amending Finance Bill for 2014, no. 2014-1655 of December 29, 2014.



- The shareholder corporation is subject to C.I.T. in its E.U. or E.E.A. Member State of establishment, without option or exemption.
- The shareholder corporation holds directly 10% or more of the capital of the distributing company.<sup>20</sup>

The dividend may be paid to an E.U. or E.E.A. permanent establishment of an eligible shareholder corporation.

To comply with the provisions of the P.S.D., the exemption has been amended to reflect the E.U.-inspired anti-abuse provision already introduced for the French D.R.D. Thus, for fiscal years beginning on or after January 1, 2016, the E.U. Directive Exemption no longer applies to dividends received if the corporate shareholder cannot provide justification that the ownership structure was chosen for a “valid” commercial purpose and not with the primary aim of obtaining the exemption.

This anti-abuse provision is not modified by the introduction of a new Principal Purpose Test (“P.P.T.”) under the domestic G.A.A.R. provisions applicable to C.I.T., which does not cover withholding taxes. This is discussed below at **General Anti-Avoidance Provisions**.

### **5% E.U. Exemption**

French sourced dividends paid to a qualifying shareholder that is not taxable in its jurisdiction of residence are exempt from withholding tax, under the following conditions:

- The shareholder benefits from an exemption regime in its country of residence. This is to say that the recipient shareholder is not able to credit the French withholding tax against its tax in the country of residence.
- The shareholder is a resident of the E.U. or of Liechtenstein, Norway, or Iceland,<sup>21</sup> provided that the recipient shareholder’s country of residence has entered into a qualifying tax treaty with France.
- The parties have not entered into an artificial arrangement for tax avoidance.
- The shares of stock owned (i) constitutes 5% of the capital and voting rights of the distributing company, (ii) is in registered form or is kept by a financial establishment, and (iii) is held for at least two years.

When the above requirements are met, the French withholding tax exemption automatically applies pursuant to the *Denkavit* case.<sup>22</sup> If the dividend is taxed in the jurisdiction of residence of the E.U. shareholder, the dividend may be paid gross if the E.U. qualifying corporate shareholder owns 10% or more of the French company making the distribution.

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<sup>20</sup> As previously mentioned, 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.

<sup>21</sup> As members of the E.E.A.

<sup>22</sup> *Denkavit Internationaal BV and Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, Case C-170/05, [2006] ECLI:EU:C:2006:783.

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.

### **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, as mentioned in the immediately preceding paragraph. Some income tax treaties have a narrow definition of dividends that restricts the application of the dividend provision to distributions that qualify as a dividend under corporate law.<sup>23</sup> Consequently, distributions that are treated as dividends under tax law rather than corporate law may not be covered by the dividend provision. Instead, they may fall under the other income provision of the treaty, leading to a withholding tax exemption in France. An example of a dividend for tax purposes that is not a dividend for corporate law purposes is an exceptional distribution of reserves.

As of the last day of June 2024, France has 122 tax treaties currently in force, as follows:

|                          |                  |               |                       |
|--------------------------|------------------|---------------|-----------------------|
| Albania                  | Estonia          | Lithuania     | Serbia                |
| Algeria                  | Ethiopia         | Macedonia     | Singapore             |
| Andorra                  | Finland          | Madagascar    | Slovakia              |
| Argentina                | French Polynesia | Malawi        | Slovenia              |
| Armenia                  | Gabon            | Malaysia      | South Africa          |
| Australia                | Georgia          | Malta         | South Korea           |
| Austria                  | Germany          | Mauritania    | Spain                 |
| Azerbaijan               | Greece           | Mauritius     | Sri Lanka             |
| Bahrain                  | Ghana            | Monaco        | St. Martin            |
| Bangladesh               | Guinea           | Mongolia      | St. Pierre & Miquelon |
| Belarus <sup>24</sup>    | Hong Kong        | Montenegro    | Sweden                |
| Belgium                  | Hungary          | Morocco       | Switzerland           |
| Benin                    | Iceland          | Namibia       | Syria                 |
| Bolivia                  | India            | Netherlands   | Taiwan                |
| Bosnia & Herzegovina     | Indonesia        | New Caledonia | Thailand              |
| Botswana                 | Iran             | New Zealand   | Togo                  |
| Brazil                   | Ireland          | Nigeria       | Trinidad & Tobago     |
| Bulgaria                 | Israel           | Norway        | Tunisia               |
| Cameroon                 | Italy            | Oman          | Turkey                |
| Canada                   | Ivory Coast      | Pakistan      | Turkmenistan          |
| Central African Republic | Jamaica          | Panama        | Ukraine               |
| Chile                    | Japan            | Philippines   | United Arab Emirates  |

<sup>23</sup> *SA Banque Française de l'Orient*, October 13, 1999, #1587.

<sup>24</sup> On March 7, 2024, Belarus announced that it would suspend the application of articles 7, 8 and 11 of the tax treaty. This temporary measure has taken effect as of June 1, 2024 and will last until December 31, 2026.

|                |             |                      |                |
|----------------|-------------|----------------------|----------------|
| China          | Jordan      | Poland               | United Kingdom |
| Colombia       | Kazakhstan  | Portugal             | United States  |
| Congo (Rep.)   | Kenya       | Qatar                | Uzbekistan     |
| Croatia        | Kirghizstan | Québec               | Venezuela      |
| Cyprus         | Kosovo      | Romania              | Vietnam        |
| Czech Republic | Kuwait      | Russia <sup>25</sup> | Zambia         |
| Denmark        | Latvia      | Rwanda <sup>26</sup> | Zimbabwe       |
| Ecuador        | Lebanon     | Saudi Arabia         |                |
| Egypt          | Libya       | Senegal              |                |

France signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on July 6, 2017 (which entered into force on January 1, 2019). The French position covers 120 of the French double tax treaties and includes several reservations.

France has either signed specific agreements concerning cross-border workers (with Germany and Switzerland - which covers only the cantons of Bern, Solothurn, Basel-Stadt, Basel-Landschaft, Vaud, Valais, Neuchâtel and Jura), or has included provisions relating to cross-border workers directly in certain tax treaties (with Italy, Spain, Belgium and Luxembourg). With the exception of the tax treaty with Luxembourg (which provides for taxation in the state in which the work is carried out in the case of remote work for 29 days a year), these agreements allow cross-border workers to continue to be taxed in their state of residence (and not in the place where they carry out their activity). France signed agreements modifying its tax treaties with Luxembourg (on November 7, 2022) and with Switzerland (on December 22, 2022). These agreements stipulate that remote work, within certain limits, may have no impact on the taxation of employment income received by cross-border workers from January 1, 2023 onwards. The agreement with Luxembourg increases the maximum duration of remote working from 29 to 34 days. The agreement with the cantons of Bern, Solothurn, Basel-Stadt, Basel-Landschaft, Vaud, Valais, Neuchâtel and Jura allows cross-border workers to work from home for up to 40% of their working time, without affecting their cross-border status or their taxation in their country of residence. The agreement with the other cantons – Zürich, Lucerne, Uri, Schwyz, Obwalden, Nidwalden, Glarus, Zug, Fribourg, Schaffhausen, Appenzell Ausserrhoden, Appenzell Innerrhoden, St. Gallen, Graubünden, Aargau, Thurgau, Ticino and Geneva – provides for the possibility of remote work while maintaining taxation in the employer’s state or location, if the remote work does not exceed 40% of their working time. This agreement will take the form of an amendment to the Franco-Swiss tax treaty. Pending signature and ratification of this amendment, France and Switzerland signed a mutual agreement on December 22, 2022, so that these rules will apply from January 1, 2023. Neither treaty modifies the scope of social security taxes.

<sup>25</sup> On August 8, 2023, the Russian president signed a decree temporarily suspending the application of international tax treaties concluded with states considered “unfriendly.” Thirty-eight states are concerned, including France. Affected portions of the treaty include Articles 5 to 22 (in particular the articles relating to permanent establishments, company profits, and reduced rates of withholding tax on passive income – dividends, interest, and royalties), Article 24 (nondiscrimination), and a significant part of the protocol to the treaty.

<sup>26</sup> The tax treaty was signed on June 22, 2023. It is not yet in force.

## **Branch Tax**<sup>27</sup>

Profits realized by foreign companies from activities conducted in France through a permanent establishment are deemed to be distributed and subject to a 25% withholding tax. (except for foreign companies located in an N.C.S.T. jurisdiction). There, the profits derived from a French permanent establishment are subject to a 75% withholding tax.

This branch tax does not apply to permanent establishment held by E.U. or E.E.A. companies, and most of the double tax treaties provide for an exemption. If applicable, the withholding tax may be adjusted in view of ex-post distributions or results.

## **TAXATION OF INTEREST**

### **Deductibility of Interest Charges**

Interest paid on a debt-financed acquisition of shares is deductible, even if the shareholder qualifies for the D.R.D., as discussed above at **Taxation of Inbound Distribution – The Dividends Received Deduction** regarding taxation of dividends below at **C.G.T. on Company Shareholdings** regarding C.G.T. relief on company shareholdings. The deduction may be limited by several provisions.

Also, a specific anti-debt push-down mechanism restricts the deductibility of interest within tax consolidated groups. See the discussion under the *Charasse Amendment* below in **Charasse Amendment (Tax Consolidations)**.

### **Interest Rate Test**

Interest expense arising from intercompany debt is 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. The maximum deductible interest rate was set at 5.57% for companies whose fiscal year ended on December 31, 2023. For the first half of 2024, the rate was set at 5.97%.

Interest expense exceeding this limit are deductible only to the extent that the company establishes that they are arm's length. The arm's length rate is determined by comparison to market practices in regard to the characteristics of the loan and the debtor, without consideration of the economic position of the group. A recent decision allows the use of rates quoted in the bond market to serve as a comparable<sup>28</sup> or a study analyzing the arm's length rate within a sample of bank loans granted to companies belonging to various business sectors.<sup>29</sup>

Intercompany interest payments that exceed the arm's length rate are treated as a distribution eligible for benefits under the D.R.D. or the terms of an applicable income tax treaty. Some tax treaties do not address deemed distributions and therefore deny France the right to tax a deemed distribution. An example is the treaty with the Netherlands.

<sup>27</sup> §115 *quinquies* of the F.T.C.

<sup>28</sup> *SAS Wheelabrator Group, Conseil d'Etat*, July 10, 2019 #429426.

<sup>29</sup> *Société Apex Tool Group, Conseil d'Etat*, December 29, 2021, #441357.



### Charasse Amendment (Tax Consolidations)

An anti-debt-push-down provision under §223B, known as the “*Charasse Amendment*,” restricts the deduction of interest expense 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. Where that occurs, the acquiring company must reduce the deduction for interest expense incurred to fund the acquisition for the year of the acquisition and the following eight years.<sup>30</sup>

### The General Interest Limitation Regime

Interest expense that is deductible after applying the foregoing tests are subject to the new set of deduction limitation rules. These rules are applicable under French tax law as from January 1, 2019, and are derived from the E.U. Anti-Tax Avoidance Directive (“A.T.A.D.”). See **§205 A of the F.T.C. – General C.I.T. Anti-Abuse Provision and Other Specific Anti-Abuse Provisions**, below, for additional discussion on the A.T.A.D.

Former French thin capitalization and interest barrier rules (*i.e.*, the “*robot*”) have been repealed and replaced by a new general limitation mechanism, pursuant to which deductible net financial expenses of a company (absent any tax group) are capped to the higher of (i) 30% of the company’s adjusted tax E.B.I.T.D.A. or (ii) €3 million. Net financial expenses that become nondeductible may be carried forward with no time limit. Unused deduction capacity may also be carried forward for five years.

Additionally, where the equity-to-assets ratio of the company is equal or greater than the equity-to-assets ratio of the consolidated accounting group to which the company belongs, 75% of the net financial expenses exceeding the 30% or €3 million thresholds may still be deducted. This 75% allowance also applies to stand-alone entities that do not belong to an accounting consolidation, that do not maintain establishments abroad no related entities.

The company’s ratio is deemed to be equal to the accounting group’s ratio if the difference between these two ratios does not exceed 2%. French law provides that this safe harbor will be applicable to companies consolidated in a global integration, under I.F.R.S. or French consolidation principles. Companies consolidated under U.S. G.A.A.P. currently fall outside the scope of this safe harbor although we may expect the French tax authorities to extend the scope of the safe harbor to U.S. G.A.A.P. when commenting on the new provisions, as they did for the repealed Carrez rules and the thin capitalization rules.

As an exception, special rules may apply if the company is thinly capitalized, *i.e.*, if its debt-to-equity ratio exceeds 1.5:1 computed only by reference to intragroup debt, thereby excluding all third-party debt, even if such debt is guaranteed by a related party. The deduction thresholds are reduced to €1 million or 10% of the adjusted taxable profits related to the interest expense on excessive indebtedness, unless this ratio is not higher than the debt-to-equity ratio of the accounting consolidation group

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<sup>30</sup> Interest expense disallowed under the *Charasse Amendment* are determined using the following formula: (interest expense of all tax group members) × (acquisition price ÷ average indebtedness of all tax group members).

to which the company belongs. In these circumstances, only 1/3rd of the nondeductible amount may be carried forward. Additionally, thinly capitalized companies may not carry forward their unused deduction capacity.

Disallowed interest expense under these limitations are not considered for the purpose of the calculation of the portion of nondeductible financial expenses under the general limitation.

Similar regimes apply to both individual entities (§212-*bis* of the F.T.C.) and French tax consolidated groups (§223 B-*bis* of the F.T.C.).

### **Withholding Tax on Interest – Exemptions**

According to §119-*bis* 1 and 125 A III of the F.T.C., a withholding tax is imposed on interest paid to a nonresident recipient. However, French domestic tax law provides for several exemptions, resulting in the almost systematic exemption from withholding tax. Three of these exemptions are outlined below for (a) interest on loans, (b) interest on bonds, and (c) interest paid inside the E.U. On the other hand, interest paid to N.C.S.T.'s are subject to 75% withholding tax in France, unless an income tax treaty provides for a lower rate.

Moving beyond domestic law, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company. For example, French income tax treaties with Germany, Austria, the U.K., Ireland, and Sweden provide 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. This exemption does not apply to interest paid to an N.C.S.T. Instead, a 75% withholding tax is applicable where (i) the interest is paid to a resident of an N.C.S.T. jurisdiction that is not on the grey list or (ii) the French borrower justifies that the transaction generating the interest payment was not principally aimed at, or resulted in, the shift of profits to the N.C.S.T. jurisdiction.

For loans contracted before March 1, 2010, interest can be paid free of withholding tax in several circumstances:

- The initial lender is a nonresident individual or legal entity that is established outside of France.
- The loan is documented by an agreement executed before the loan proceeds are transferred to the French company.
- 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.

*“Moving beyond domestic law, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company.”*

### 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 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 or 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

Interest is exempt when the recipient is an eligible E.U. company that is subject to C.I.T. in its jurisdiction of residence and the payer and the beneficial owner are related parties. Parties will be treated as related where (i) the payer directly owns at least 25% of the capital of the beneficial owner of the payment, (ii) the beneficial owner of the payment owns at least 25% of the payor, or (iii) a third E.U. company directly holds at least 25% of the capital of both the payer and the beneficial owner of the payment. The ownership interest must be held for at least two years. Payments made before the expiration of the 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 payer or beneficial owner of the payment as long as the interest is subject to C.I.T. in the E.U. Member State in which the permanent establishment is located. The beneficial owner of the payments must give the payer all required evidence that the tests have been fulfilled.

An anti-abuse provision denies the exemption 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. However, this provision is of little interest when the double tax treaty applicable between France and the jurisdiction of the controlling shareholder provides for an exemption of withholding tax. The U.S. is one such example.

## **TAXATION OF REMUNERATION OF SERVICES AND ROYALTIES ON I.P.**

### **Taxation of Outbound Payments**

The payment of fees to foreign companies that do not have a permanent establishment in France are subject to a withholding tax equal to the standard rate of C.I.T. (25%).<sup>31</sup> when the payment relates to (a) services provided or used in France or (b) royalties for the use of intangible property in France. This rate is increased to 75% for payments made to companies established in an N.C.S.T. jurisdiction.

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<sup>31</sup> §182 B of the F.T.C.

The criteria of services used or provided in France may be interpreted quite broadly. For example, the Supreme Tax Court has ruled that services paid to a Hong-Kong company who performed scouting services (identification of furnishers) for a French company were used in France to make business decisions.<sup>32</sup>

Payments made between related E.U./E.E.A. companies are exempted from withholding taxes under the same conditions as the interest payments. In addition, withholding taxes on payments to loss-making E.U./E.E.A. companies may be refunded.

### **Taxation of Inbound Payments for Services**

Remuneration of services are taxable under normal C.I.T. rules.

### **Taxation of Inbound Royalties - Industrial Property (“I.P.”) Box Regime**

Further to the O.E.C.D. B.E.P.S. Action 5 Report, France has amended its I.P. box regime.

The former French I.P. box regime consisted in a distinct taxation of I.P. income at a reduced rate of 15%. The benefit of the reduced rate was not connected to the location of research and development (“R&D”) expenditures in France. Therefore, the O.E.C.D. considered that this regime was not in line with the nexus approach.

As a result, France adopted the nexus approach which is intended to condition the I.P. box regime in a given jurisdiction to R&D activity resulting in expenditures in the same jurisdiction. The eligible net R&D income after deduction of R&D expenditures is taxed at the rate of 10%.

The new regime was introduced by the Finance Act for 2019 and is codified in §238 of the F.T.C. This regime is optional and applies to tax years beginning on or after January 1, 2019. Election is made for each asset, good or service, or family of goods or services in the tax return for the financial year in respect of which it is exercised. The election must be renewed each financial year. If not, the benefit is terminated. It applies to standalone entities and French tax consolidated groups.

### **Eligible Intangible Assets**

Eligible assets include patents, analogous rights, plant variety certificates, software protected by copyright, industrial manufacturing processes resulting from research activities and which constitute an essential complement to the patent or utility certificate with which they have been transferred or licensed, and inventions whose patentability has been confirmed by the French National Institute of Intellectual Property (“N.I.I.P.”). Initially, non-patented assets whose patentability was certified by the N.I.I.P. were included. However, the announced application decree was never published, and non-patented assets were formally excluded from §238 of the F.T.C.

### **Application of the Nexus Approach**

According to §238 of the F.T.C., the qualifying I.P. income must be determined in three stages.

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<sup>32</sup>

*Société Sud Trading, Conseil d’Etat, October 22, 2018, #406576.*



### Stage 1: Determination of the Net Profit

The net profit that is entitled to the reduced tax rate is the gross incomes derived from the licensing, sublicensing, or transfer of an intangible asset for the financial year minus R&D expenditures directly linked to this asset, incurred directly or indirectly by the taxpayer during the same period.

### Stage 2: Determination of the Nexus Ratio

The nexus ratio is used to determine the portion of the net profit determined in Step 1 that is attributable to the taxpayer. To compute the ratio, the qualifying expenditure directly related to income derived from the I.P. rights and directly incurred by the taxpayer or by unrelated companies engaged by the taxpayer is divided by the sum of (i) the foregoing expenditures, (ii) comparable expenditures incurred by related parties, and (iii) the cost of acquiring I.P. assets such as the purchase of a patent. In broad terms the nexus ratio measures (a) the contribution of the taxpayer to the R&D activity in relation to (b) all contributions of related parties plus the cost of acquiring I.P. assets.

Qualifying expenditures are R&D expenditures directly related to the creation and development of the intangible asset carried out directly by the taxpayer or outsourced to unrelated entities. These expenditures should include salaries, direct costs, patent maintenance costs, overhead costs directly related to R&D facilities, and supply costs. Interest payments, building costs, and acquisition costs are excluded.

This ratio will be calculated on a cumulative expenditure basis and must be updated each year. A taxpayer may limit the amount of overall expenditure to those expenditures incurred beginning as of January 1, 2019. Qualifying R&D expenditures incurred by the taxpayer may be increased by 30%, but the taxpayer's share cannot exceed 100%. The increase does not apply to qualifying expenditures of related parties or the cost of acquiring an I.P. asset.

The nexus ratio is calculated for each financial year and takes into account the expenditures incurred by the taxpayer for that year and prior years for both the numerator and denominator. Consequently, the determination of the nexus ratio requires monitoring all R&D expenditures relating to qualifying assets that have been the subject of the election for this preferential regime.

The 30% buffer does not apply to the qualifying expenditures included in the overall expenditures.

### Stage 3: Application of the Nexus Ratio to The Net Profit

In the final stage, net profits are multiplied by the nexus ratio and the result benefits from the reduced tax rate.

### Safeguard Clause for Exceptional Circumstances

As allowed by the O.E.C.D., France treats the nexus ratio as a rebuttable presumption. It enables taxpayers to prove that more income should be permitted to benefit from the regime in exceptional circumstances.



## **Filing Obligations**

The company must attach an appendix to the tax return each year, detailing the calculations used to determine the eligible income and the nexus ratio.

Companies must maintain proper documents, including a general description of the organization of the R&D activities and specific information concerning the determination of taxable income. This information must be made available to French tax authorities at the time of examination. Failure to produce the required full documentation within 30 days of receipt of formal notice triggers the imposition of a 5% fine for each year under examination. The basis of the fine is equal to the income derived from qualifying assets that have been the subject of such breach.

## **TAXATION OF CAPITAL GAINS**

### **Territoriality**

Capital gains realized on the transfer of French shares by foreign companies are taxable in France if the seller holds a stake of at least 25% of the transferred company at any point within the five-year period preceding the transfer. If an applicable double tax treaty does not provide otherwise, the gain is taxable at normal C.I.T. rate.

A special rule applies to the gains of companies having their place of effective management in an E.U. Member State, or a Member State of the E.E.A. These companies may benefit from an exemption from the Capital Gain Tax (“C.G.T.”), provided that the French company is not a real estate company.

Capital gains realized by foreign seller on transfer of shares in French real estate companies are taxable in France at normal C.I.T. rates, subject to the application of a double tax treaty.

Capital gains realized by a seller located in an N.C.S.T. jurisdiction are subject to 75% tax, no matter the size of the stake maintained in the French company. This treatment is subject to the application of a double tax treaty providing for beneficial treatment of capital gains.

### **C.G.T. on Company Shareholdings**

Gains on the sale of shareholdings (“participations”) are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for capital gains tax relief. Such relief is available in the form of an exemption or a reduced tax rate.

C.G.T. on long-term shareholdings covers gains on the disposal of participations, meaning shares or interests that the shareholder intends to hold as long-term investments, *viz.*, at least two years. The shares must provide the shareholder with control of, or significant influence over, the company.

These tests are deemed satisfied if the shareholder holds 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 a company that is resident in an N.C.S.T. jurisdiction cannot qualify for the C.G.T. relief.

The holding conditions must be met at the time of the sale of the participations,<sup>33</sup> but not necessarily throughout the entire holding period.

If for a given year, the capital losses on substantial shareholdings fully offset the capital gains on substantial shareholdings, no tax is due on the capital gains realized. However, because a portion of the exempt capital gain is subject to a 12% add-back, a portion of the gain will be taxed. In essence, the effective tax rate on the gain from the disposal of shares is 3.10%, in the absence of an applicable N.O.L.<sup>34</sup> The 12% addback is calculated from the amount of exempted gross capital gains. Capital losses do not reduce the addback. As a result, any withholding taxes levied abroad on capital gains may be credited against the C.I.T. due on this disallowed amount.<sup>35</sup>

### **C.G.T. on Real Estate Holding Companies**

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 19.63% effective tax rate, if the substantial shareholding requirements are met.<sup>36</sup> Disposal of shares of unlisted real estate holding companies are subject to the standard C.I.T. rate.

### **C.G.T. on Venture Capital Vehicles**

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 15.5% effective tax rate).

### **C.G.T. on Short-Term Shareholdings – Anti-Abuse Provision for Intercompany Transactions**

Deductions for short-term capital losses incurred upon the transfer of shares held for less than two years to a related party are deferred until the shares are effectively transferred to an unrelated party.

## **ANTI-AVOIDANCE PROVISIONS**

### **General Anti-Avoidance Provisions**

The Finance Act for 2019 introduced several new anti-abuse provisions. The reforms aim at introducing the principal purpose test in French G.A.A.R. without being in breach of the Constitution.

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<sup>33</sup> BOI-BIC-PVMV-30-10 #260.

<sup>34</sup> Based on a 25% standard C.I.T. rate increased by the 3.3% surcharge mentioned above at **Corporation Income Tax – General**.

<sup>35</sup> *Air Liquide, Conseil d’Etat*, November 15, 2021, #454105.

<sup>36</sup> This consists of the 19% tax rate increased by the 3.3% surcharge mentioned above.

*“The G.A.A.R. tackles an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances.”*

### §L. 64 of the of Tax Procedures Code (“B.T.P.”) – Existing Exclusive Motivation Test

Under the existing motivation test, the F.T.A. may disregard a transaction on the grounds that (i) it has a fictitious character or (ii) it aims at obtaining a formal application of a legal provision or decision in violation of its purpose and is exclusively motivated by the objective of reducing the taxes which normally would have applied to the actual transaction. Penalties may be imposed that range from 40% for gross misconduct to 80% for tax fraud under §1729 of the F.T.C.

### §L. 64 A of the B.T.P. – Main Abuse of Law

The Finance Act for 2019 introduced a new abuse of law provision under §L.64 A of the B.T.P. that applies to tax reassessments issued since January 1, 2021, relating to transactions carried out from January 1, 2020. Under the new provisions, the F.T.A. may disregard a transaction on the grounds that the transaction results in merely a formal application of legal provisions or decisions in a way that violates their purpose and is mainly motivated by the objective of reducing taxes which “normally” would have applied to an “actual” transaction.<sup>37</sup>

The scope of the new provision is broader than the scope of §L. 64 of the B.T.P., that applies when the tax savings are the exclusive reason for entering the transaction. The threshold for applying §L.64 A of the B.T.P. is lower because tax savings need be only a main purpose. In addition, §L.64 A of the B.T.P. applies to all taxes. §L.64 A of the B.T.P. does not provide for specific penalties. However, normal penalties of 40% willful wrongdoing under §1729, a) of the F.T.C. should apply.

### §205 A of the F.T.C. – General C.I.T. Anti-Abuse Provision

To comply with Article 6 of the A.T.A.D., France introduced a G.A.A.R. by enacting §205 A of the F.T.C. This provision applies only to corporate income tax and is effective for financial years beginning on or after January 1, 2019. However, transactions initiated before January 1, 2019, may be subject to this new rule if they entail tax consequences over financial years beginning on or after the effective date.

The G.A.A.R. tackles an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement or a series of arrangements will be regarded as nongenuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

A parliamentary report issued in connection with the enactment of G.A.A.R. indicates that the term must be interpreted in the light of the case law of the E.C.J. In addition, a private ruling procedure has been introduced to assist companies undertaking specific transactions.

### **Other Specific Anti-Abuse Provisions**

Specific anti-abuse provisions apply to the withholding taxes on outbound dividends (§119ter of the F.T.C.) and the favorable roll-over tax regime applicable to mergers

<sup>37</sup> *Société Orange, Conseil d'Etat, January 27, 2023, #463883.*

(§210-A of the F.T.C.). They are derived from the A.T.A.D. and have the same wording as §205 A of the F.T.C.).

The exact demarcation between all newly enacted anti-abuse rules is somewhat nebulous. Guidelines of the F.T.A. published in January 2020<sup>38</sup> tend to confirm that the F.T.A. has discretion as to which standard should be applied in attacking abusive arrangements, with a choice between using the exclusive or the main abuse-of-law provision. In both cases the F.T.A. must initiate a specific procedure.

### Subject to Tax Limitation

Outbound payments made to foreign entities that are subject to an effective tax rate lower than 40% of what would have been the tax liability in France are nondeductible for tax purposes (§238 A of the F.T.C.). The threshold applies to payments of interest, royalties, and remuneration for the performance of services.

Deductibility may be granted if the taxpayer demonstrates that (i) the payments are made for actual operations and (ii) the payments are not abnormal or disproportionate. If the beneficiary is established in an N.C.S.T. jurisdiction, the taxpayer must demonstrate that the payments have a primary effect or purpose other than locating profits in the N.C.S.T. jurisdiction.

### Controlled Foreign Corporation (“C.F.C.”) Legislation

Section 209 B is the French counterpart to 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 France-Switzerland Income Tax Treaty.<sup>39</sup> 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 income tax treaty applicable between France and Switzerland 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 revised.

In its current version, C.F.C. rules apply when a French company or a P.E. located in France holds directly or indirectly more than 50% of the shares of an entity located in a foreign country. It includes legal entities that are or are not distinct from their shareholders, it also includes trusts.

The holding threshold drops to 5% if (a) 50% of the legal entity is held directly or indirectly by other related French or foreign entities that control or are under the control of the first French company<sup>40</sup> or (b) 50% is owned or controlled by unrelated entities acting together.

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

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<sup>38</sup> BOI-CF-IOR-30-20.

<sup>39</sup> *Ministre de l’Economie, des Finances et de l’Industrie c/ Sté Schneider Electric, Conseil d’Etat*, June 28, 2002, #232276, RJF 10/02 #1080.

<sup>40</sup> 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.

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 effectively subject to C.I.T. at an effective tax rate lower than 40% of the French C.I.T. that a French company would have paid on the same income.

If a French entity holding subsidiaries outside the E.U. falls in the scope of the C.F.C. rule, its share in the profits of the C.F.C. are added to French taxable income and treated as “deemed distributions.” In determining the amount of the inclusion, the foreign profits will be recomputed under French standards, and several adjustments must be implemented. Unless specifically addressed, double tax treaties are of no protection against the C.F.C. rule.

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. Also, taxes paid by the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company as credits to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

#### E.U. Safe Harbor

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 French tax legislation. This provision follows the case law developed by the E.C.J., particularly *Cadbury Schweppes*.<sup>41</sup> 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 and that the subjective intent of the establishment was not material with regard to tax planning.

#### General Safe Harbor

A second exclusion (the “Trade or Business Exclusion”) may apply to C.F.C.’s established in non-E.U. countries.

This exclusion provides that C.F.C. rules does not apply if the primary purpose of the operation is not the generation of local profits in the foreign jurisdiction. This condition is deemed fulfilled when the foreign entity conducts effective business operations through a facility in the foreign jurisdiction.

French administrative guidelines provide that the exclusion also applies to entities deriving passive income from financial activities or the management of intangibles 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, the management of intangibles, and services rendered to affiliates. In either case, the French taxpayer must demonstrate that the use of the foreign entity or enterprise does not primarily result in moving profits to a low-tax jurisdiction.

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<sup>41</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995; see also *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes)*, Case C-264/96, [1998] E.C.R. I-04695, and guidelines issued by the F.T.A. dated January 16, 2007 (4-H-1-07).



C.F.C.'s established in an N.C.S.T. jurisdiction do not benefit from the trade and business exclusion unless the taxpayer can justify the substance of the business carried out and comply with the 20% and 50% ratios.

### Anti-Hybrid Test

#### Provisions Applicable to Fiscal Years Beginning Before January 1, 2020

In an effort to curb the use of hybrid instruments, France unilaterally introduced an anti-hybrid mechanism. This mechanism disallowed interest expense deductions in cases where it could not be proven that the interest payment was 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.

The rate comparison referred only to the tax regime applicable to the gross income received from France. It did not refer to the effective tax rate of the recipient entity. Consequently, expenses and losses that could reduce the taxable result of the foreign company were disregarded when applying this test. Also, negative adjustments to income under foreign tax consolidation regimes were not considered.

The application of the anti-hybrid rule did not preclude application of the French general anti-avoidance rules.

#### Provisions Applicable to fiscal Years Beginning on and After January 1, 2020

The provisions of E.U. Directive 2017/952 (“A.T.A.D. 2”) have been integrated into French tax law by Finance Act for 2020. These provisions replace the previous subject-to-tax provisions.

The anti-hybrid regime derived from A.T.A.D. 2 tackles tax asymmetries occurring in the course of (i) intercompany payments, (ii) payments between headquarters and permanent establishments, and (iii) payments between permanent establishments of a same entity. These asymmetries include the following transactions:

- Payment pertaining to a financial instrument that leads to a deduction in State A and a non-inclusion in State B, because of an asymmetry of characterization of the instrument or the payment
- Payment made to a hybrid entity that entails a deduction in the State of the payor and non-inclusion in the State of residence of the hybrid entity, because of an asymmetry in the description of the payment between the State of residence of the hybrid entity (no income recognized from a wholly internal transfer) and the State of residence of the stakeholders in the hybrid entity (deduction recognized from a payment to a related entity)
- Payments to an entity having several permanent establishments, that entails a deduction in the State of the payor and no inclusion in the State of residence of the entity, because of an asymmetry of attribution of the payment between the State of residence of the entity (deduction recognized from a payment to a related entity) and the State of the permanent establishment, or among the States in which different permanent establishments are maintained (no income recognized)

- Payments to a permanent establishment that entails a deduction in the State of the payor and no inclusion in the State of the establishment, because the establishment is not recognized in the State of its location
- Deemed payments between a permanent establishment and its headquarters, or between different permanent establishments that entails a deduction in the State of the payor and no inclusion in the State of the beneficiary, because the State of the beneficiary does not recognize the payment
- Deductions allowed in each of two states for the same payment

Such asymmetries will generally trigger the reversal of the tax deduction claimed in France.

A grandfather rule applies to test the interest expense deduction under the subject-to-tax test. Interest payments made to beneficial owners under a grandfathered transaction that is resident abroad and subject to tax at a rate that is at least 25% of the French C.I.T. rate will continue to be deductible, provided that (i) they are supported by valid business rationale and (ii) they do not fall into one of the situations tackled by the A.T.A.D. 2 provisions.

### *Noncooperative States and Territories*

Since 2010, specific French tax legislation addresses French companies entering into transactions with companies that are resident in an N.C.S.T. jurisdiction. This legislation was revised by the Finance Act for 2019, enacted in December 2018.

Under the current version, the N.C.S.T.'s are defined (i) by reference to the French appreciation of the exchange of information and (ii) also by reference to the E.U. list of noncooperative jurisdictions for tax purposes adopted by the Council of the E.U. conclusions on December 5, 2017 and updated periodically.

For purposes of the French list, a country or territory is defined as an N.C.S.T. if it meets the following criteria:

- It is not a Member State of the E.U.
- 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”).
- It has not signed a T.I.E.A. with France.

The N.C.S.T. was updated in February 2024 and now encompasses Anguilla, Antigua & Barbuda, Belize, Fiji, Guam, the U.S. Virgin Islands, Palau, Panama, U.S. Samoa, Samoa, Seychelles, Russia, Trinidad & Tobago, the Bahamas, Turks & Caicos, and Vanuatu.

For the purposes of the E.U. list, reference is made to decisions of the Council of the E.U. Jurisdictions on the E.U. list are treated differently according to the rationale behind their rostering. Jurisdictions that facilitate offshore structures and arrangements aimed at attracting profits without real economic substance may receive extensive French anti-abuse treatment. In comparison, jurisdictions that do not meet



at least one of the criteria on tax transparency, fair taxation, and implementation of anti-B.E.P.S. measures may receive only limited French anti-abuse treatment (so-called “grey list”).

On February 20, 2024, the Council of the E.U. revised the E.U. list of noncooperative jurisdictions. The updated list includes 12 jurisdictions: Anguilla, Antigua & Barbuda, Fiji, Guam, Palau, Panama, Russia, American Samoa, Samoa, Trinidad & Tobago, the United States Virgin Islands, and Vanuatu. The jurisdictions mentioned on the E.U. list may be removed in the future if they make significant efforts to meet E.U. tax standards.

The French tax consequences for transactions with N.C.S.T.’s are effective as from the first day of the third month following the publication of a specific governmental order.

The Finance Act for 2019 also introduced several safe harbors shielding transactions with an entity or an account located in an N.C.S.T. that are not mainly intended to attracting profits to an N.C.S.T.

Where one of these countries is involved, French tax law provides for a significantly increased tax rate, tightened anti-abuse of law provisions, or exclusion from favorable tax regimes.

## OTHER TAX ITEMS

### **Cooperation with the Tax Authorities**

#### *Fiscal Partnership and Fiscal Support*

The Act for a Trustful Society of August 2018<sup>42</sup> introduced two services of cooperation between companies and the tax authorities.

#### Fiscal Partnership

The fiscal partnership aims at large companies and groups that wish to establish a constant dialogue with the tax authorities regarding strategic or delicate matters. This option is restricted to companies that fulfilled their tax obligations for the three preceding years and have not received any penalty for willful wrongdoing. A tax official is appointed to follow the company and work with the company to identify regulatory issues. The company can correct its mistakes without penalties. The examination of issues leads to the issuance of rulings that bind the tax authorities for the future. The partnership can be terminated without notice or penalty.

#### Fiscal Support

The fiscal support aims at S.M.E.’s that seek cooperation on specific operations. This program is available to companies that satisfy the definition of an S.M.E. under E.U. law.<sup>43</sup> The support is addressed to growth companies, innovative companies, or companies that operate in strategic sectors. Like the fiscal partnership, this program is limited to companies that have been compliant for the three preceding years

<sup>42</sup> LOI 2018-727, 10 August 2018, §17.

<sup>43</sup> Meaning less than 250 employees and a turnover lower than €50 million, or a balance sheet that does not exceed €43 million.

*“The French tax consequences for transactions with N.C.S.T.’s are effective as from the first day of the third month following the publication of a specific governmental order.”*

and have not committed willful wrongdoings. An official is appointed by the tax authorities to work with the company to identify the issues that could benefit from a formal position of the authorities. Most notably, it concerns recurring operation with high financial implications, or punctual operation that are key in its development. The position is formalized by a binding ruling from the French tax authorities.

### **Regularization Service**

This new service is in charge of helping companies and their managers with the regularization of their situation. Eligible demands are limited to (i) irregularities discovered before or after the takeover of a company, (ii) certain issues related to international tax, such as the existence of a P.E., the allowance of a deduction for the payment of outbound interest, and noncompliant arrangements), (iii) the taxation of managers, and (iv) arrangements that expose the company to 80% penalties.

Under the program, the company makes full disclosure to the tax authorities of compliance shortfalls. The company undertakes to comply with future tax obligations. In exchange, taxpayer benefits from lower penalties. The common 80% fraud or abuse of law penalty, the 40% willful wrongdoing penalty, and 10% failure to file penalty are reduced to 30%, 15%, and nil, respectively. Late payment interest will also be reduced by 40% or 50% for the absence of filing.

The program is initiated by the taxpayer. It must be initiated prior to the start of an audit or the receipt of an inquiry from the French tax authorities. The taxpayer submits an information packet that accompanies its request for relief. The tax authorities may request additional information, and if resolution is not obtained with the officer assigned by the tax authorities, the case can be appealed to a higher ranking official.

### **Fraud Act**<sup>44</sup>

The Fraud Act of October 23, 2018, gives significant tools to the F.T.A. in its fight against tax avoidance and tax fraud.

#### **Name and Shame**

The F.T.A. may publish information regarding tax penalties imposed on a company, as a result of a fraudulent arrangement or abusive transaction, when the amount equals or exceeds €50,000. Before information on the penalties can be published, the F.T.A. must obtain the approval of a special commission that is empowered to review tax offences (“*commission des infractions fiscales*”). If approval is given, the corporation is allowed a period of 60 days to lodge an appeal, which suspends publication. If no appeal is lodged, the name of the taxpayer and the amount of penalties imposed will be listed on the F.T.A. website. The publication lasts for not more than one year. The F.T.A. must also publish any court decision in favor of the company if the assessment is successfully challenged in court.

#### **Tax Offenses and Criminal Prosecution**

The Fraud Act, which came into effect on October 24, 2018, introduced major changes in the criminal prosecution of tax offenses. Under prior law, the F.T.A. exercised

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<sup>44</sup> *Renforcer Les Moyens Alloués À La Lutte Contre La Fraude Fiscale, Sociale Et Douanière*, LOI no. 2018- 898, October 23, 2018.

discretion in choosing the cases to transfer to the public prosecutor. Now, the F.T.A. must report all tax cases to the public prosecutor involving reassessments exceeding €100,000 (€50,000 for certain taxpayers) and the assertion of the following civil penalties:

- 100% tax penalties imposed because the taxpayer took steps to prevent the tax audit.
- 80% tax penalties imposed because the taxpayer took steps to hide assets or income, committed tax fraud, followed a plan that amounted to an abuse of law, failed to declare assets located abroad, or secretly placed assets in a foreign trust.
- 40% tax penalties imposed because the taxpayer failed to pay tax within 30 days of a notice, took action amounting to deliberate misconduct or abuse of law.

The public prosecutor decides whether to pursue a criminal investigation.

The F.T.A. retains discretion to report matters that do not fall within the foregoing categories.

Upon approval by the commission des infractions fiscales, the F.T.A. may recommend cases to the public prosecutor for criminal prosecution. In these cases, a criminal complaint must be lodged within six years of the close of year in which the offense was committed. Once the criminal investigation begins, the discovery of new facts of tax fraud committed by the same taxpayer, including those related to other years or other taxes, may expand the scope of the investigation.

Conviction of the criminal offense of tax fraud may result in a penalty of up to €500,000 penalty and a prison term of up to five years. The penalty may increase to €3 million in cases involving complex frauds and organized frauds. The criminal penalties are applied in addition to civil tax penalties.

The Fraud Act provides that the penalty may be increased to twice the financial benefit derived by the defendant.

### **Advisor's Disclosure and Penalties**

#### **Law on Reinforcement of The Fight Against Fraud**

The Fraud Act introduced a disclosure obligation for legal and accounting advisors involved in the design or implementation of aggressive tax planning arrangements. Advisors who assist taxpayers with transactions that result in the 80% civil penalty may face their own penalty exposure. The amount of the fine is the greater of 50% of the advisor's fees or €10,000.

#### **Directive 2018/822**

France has transposed the E.U. Directive 2018/822<sup>45</sup> ("D.A.C. 6") into its national law. This Directive created an obligation for intermediaries to report certain potentially

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<sup>45</sup> Council Directive 2018/822/E.U. Amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2018 O.J. L 139/1.

aggressive cross-border tax planning arrangements to tax authorities within 30 days of implementation. This Directive adopts broad definitions of both intermediaries and reportable cross-border arrangements.

An intermediary is anyone who designs, markets, organizes, makes available, or implements a reportable arrangement or anyone who helps with reportable activities and knows or could reasonably be expected to know the effect of their advice. The targets are lawyers, in-house counsel, underwriters, capital providers, insurance brokers, accountants, and financial advisors.

Reportable cross-border arrangements contain at least one of the hallmarks listed in D.A.C. 6 as indicative of a potential risk of tax avoidance. If an intermediary is unable to submit a report due to a professional privilege recognized under law, the obligation to disclose falls on the taxpayer. Advisors must inform clients involved in a reportable transaction of their obligation to disclose.

Arrangements implemented between June 25, 2018, and July 1, 2020, had to be reported by February 28, 2021. Arrangements subject to declaration obligations due between July 1, 2020 and December 31, 2020 had to be reported by January 31, 2021.

D.A.C. 6 has been transposed in §1649 AD to AH of the F.T.C. The French tax authorities have issued guidelines on its scope of application and on the relevant definition of the hallmarks in November 2020.<sup>46</sup> The reporting obligation applies to eligible operations implemented since June 25, 2018. Information seems to reveal that the French market has been shy in filing D.A.C. 6 reports in comparison to other E.U. countries.

### **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 taxpayers that fit into one of several categories:

- French companies with a gross annual turnover or gross assets equal to or exceeding €150 million.<sup>47</sup>
- 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 €150 million threshold.<sup>48</sup>
- French parent companies that directly or indirectly own at least 50% of companies meeting the €150 million threshold.<sup>49</sup>

<sup>46</sup> BOI-CF-CFP-30-40.

<sup>47</sup> This threshold has been lowered for financial years beginning on or after January 1, 2024. Before this date, the threshold was €400 million.

<sup>48</sup> €400 million for financial years ending on December 31, 2023.

<sup>49</sup> *Ibid.*

**“Reportable cross-border arrangements contain at least one of the hallmarks listed in D.A.C. 6 as indicative of a potential risk of tax avoidance.”**

- Worldwide-consolidated without any financial threshold or tax-consolidated French companies with at least one tax-consolidated entity meeting the €150 million threshold within the perimeter.<sup>50</sup>

The documentation corresponds to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European Commission (“the Commission”). It 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, such as a description of its activities and transactions, including a presentation of the transfer pricing method used to test controlled transactions. The latter is known as the country-specific file. This documentation must be presented to the F.T.A. when the company is audited.

The documentation must be well supported. Indeed, where the transfer pricing method applied deviates from that specified in the documentation, the discrepancy between the accounting result and the amount it would have been if the documentation had been complied with is deemed to constitute an indirect transfer of profit. This can be avoided only if the entity demonstrates the absence of a transfer either by increasing or decreasing the purchase or sale price, or by some other means.<sup>51</sup>

If the company fails to provide the documentation, a fine amounting to the greatest of €50,000,<sup>52</sup> 5% of adjusted profits,<sup>53</sup> or 0.5% of the amount of the transactions may be imposed.

Entities described below must electronically file an annual simplified transfer pricing form within the six-month period following the filing of their tax return:

- French companies with a gross annual turnover or gross assets equal to or exceeding €50 million
- 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 €50 million threshold
- French parent companies that directly or indirectly own at least 50% of companies meeting the €50 million threshold
- Worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €50 million criteria within the perimeter)

Where transactions carried over from affiliated companies involve amounts below €100,000 per type of transaction, the simplified transfer pricing documentation is not required.

The law does not provide a specific penalty for the failure to file. Therefore, the general penalty of €150 per document provided by §1729 B of the F.T.C. should

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<sup>50</sup> *Ibid.*

<sup>51</sup> This results from the modification of §57 of the F.T.C. as per the 2024 Finance Bill.

<sup>52</sup> The fine has been increased by the 2024 Finance Bill. Before January 1, 2024, the minimum fine was €10,000.

<sup>53</sup> The actual rate will depend on the behavior of the company.

apply for each document that is not filed. In cases where some items are missing or inaccurate in a document, the penalty is equal to €15 per item with a minimum penalty of €60.

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 reach an advance transfer pricing agreement with the F.T.A. The advance pricing agreement can be unilateral, bilateral, or multilateral. The French program is efficient and pragmatic.

Finally, in accordance with the O.E.C.D.'s B.E.P.S. Action Plan, the Finance Bill for 2016 introduced Country-by-Country ("C-b-C") Reporting obligations for French companies that (i) control foreign subsidiaries or have permanent establishments overseas and (ii) have a consolidated turnover exceeding €750 million. The taxpayer must report the activities and places of activity of the entities in the group and information about profit splitting among these entities. The goal of C-b-C reporting is to provide tax authorities with an overview of the states where expenses, income, and profits are located, and are likely to support future reassessments.

According to §223-quinquies C of the F.T.C., C-b-C reporting is mandatory for international groups that meet the turnover threshold and have either a French permanent establishment or a French subsidiary except when they are subject to a similar obligation in their respective country of residence. French entities that are held by foreign companies subject to a similar obligation in their respective country of residence are not subject to C-b-C reporting in France.

The reporting obligations must be fulfilled within 12 months after the closure of the annual accounts. Failure to comply with the requirements will trigger the imposition of a penalty which cannot exceed €100,000 for each violation.

A European directive<sup>54</sup> provides for a similar mechanism at the E.U. level. Under the directive, the mandatory exchange of information between the European tax administrations is extended to include the automatic exchange of information on the C-b-C Report.

A directive was adopted at the end of 2022 requiring multinational companies with a consolidated turnover exceeding €750 million for two consecutive financial years to make certain economic, accounting and tax information, which partly overlaps with the C-b-C Report, available to the public (publication).<sup>55</sup> This has been enacted into law and will apply for financial years beginning on or after June 22, 2024.<sup>56</sup>



<sup>54</sup> Council Directive 2016/881/E.U. amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2016 O.J. L 146/8.

<sup>55</sup> European Parliament Directive 2021/2101 of November 24, 2021.

<sup>56</sup> Law no. 2023-171 containing various provisions for adapting to European Union law in the fields of the economy, health, labor, transport and agriculture (DADUE 3), March 9, 2023.

## **Transfer Taxes**

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares, the following rates generally apply:

- A fixed tax rate of 0.1% applies to transfers of shares of stock issued by a French S.A., S.C.A. or S.A.S. – except if the entities qualify as real estate holding companies for tax purposes. Also, intragroup transactions can benefit from a transfer tax exemption.
- Transfers of units issued by French partnerships, the capital of which is not divided into shares of stock 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:

- Transfers of real property assets located in France are subject to tax at a rate of 5.09% or 5.81%.<sup>57</sup> A 0.6% additional tax applies to the sale of assets allocated to a commercial purpose (e.g., offices, retail, or storage) that are located in the Île-de-France region (and in some cases, such transfers may be subject to V.A.T. instead).
- A progressive tax rate applies for transfers of business as going concerns (“*fonds de commerce*”) or goodwill: (i) 0% for the portion of the transfer price below €23,000, (ii) 3% for the portion between €23,000 and €200,000, and (iii) 5% for the portion exceeding €200,000.

## **B.E.P.S., A.T.A.D., AND FRANCE**

### **B.E.P.S.**

France is one of the founding members of the O.E.C.D. and is highly involved in the O.E.C.D.’s work relating to the B.E.P.S. Project. Soon after the publication of the O.E.C.D. report entitled “Addressing Base Erosion and Profit Shifting” in February 2013, the Parliament Commission of Finances released a report on the same topic, which reaffirmed the 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 actively encourages the E.U. 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

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<sup>57</sup> The tax rate applicable depends on the location of the asset.

***“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.”***

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. A French digital services tax was created in 2019 in § 299 and sq. of the F.T.C.

In the context of the digital economy, the French government places high priority on (i) the elimination of inappropriate double nontaxation, (ii) the reinforcement and effectiveness of anti-avoidance rules, and (iii) addressing profit shifting issues. B.E.P.S. issues are regularly debated in commissions and assemblies of French Parliament, and several legal provisions have been introduced in recent finance bills. These include the following:

- The modification of the abuse-of-law provisions from an exclusively tax-driven test to a *principally* tax-driven test.
- The amendment of the I.P. box regime to comply with the “nexus approach” preconized by the O.E.C.D.
- The limitation of the D.R.D. regime to exclude dividends that were deducted from the distributing company’s taxable income<sup>58</sup> and dividends that are paid when the ownership structure cannot be considered genuine because it is not justified by a valid commercial reason.
- 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.
- The annual C-b-C Reporting requirements for French companies controlling foreign entities or having permanent establishments overseas.

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.

Recent results in tax examinations indicate that tax auditors take positions based on the current work of the O.E.C.D. regarding B.E.P.S., even if those positions are not compliant with current French tax law. Such action gives rise to questions about the potential for double taxation unless a multilateral policy is adopted.

In December 2022, the European Union adopted a directive that essentially incorporates the O.E.C.D. rules regarding Pillar Two. The companies concerned will have to calculate an effective tax rate in each of the jurisdictions in which they operate, and will be liable for a top-up tax if this rate is lower than the minimum rate of 15%.

The 2024 Finance Bill transposed the European Pillar Two Directive into French law, in §223 V.J. of the F.T.C. France has opted for a qualified domestic top-up tax.

<sup>58</sup> Transposition of Council Directive 2014/86/E.U. of July 8, 2014.



Therefore, French entities of groups within the scope of Pillar Two that do not meet the safe harbor rules and for which the effective tax rate would be below 15% will be liable to pay the qualified domestic top-up tax in France.

The new rules will apply to fiscal years beginning on or after December 31, 2023, except the undertaxed profits rule which will apply to fiscal years beginning on or after December 31, 2024.

### **A.T.A.D.**

On July 12, 2016, the European Council adopted the A.T.A.D.<sup>59</sup> The scope and the measures of this Directive regarding hybrid mismatches were further enlarged by the A.T.A.D. 2 of May 29, 2017.<sup>60</sup>

A.T.A.D. builds on the principle that tax should be paid where profits are made. It includes legally binding measures to block the methods most commonly used by companies to avoid paying tax. It also proposes common definitions of terms such as permanent establishment, tax havens, transfer prices, royalty costs, patent boxes, and letterbox companies.

France transposed several A.T.A.D. provisions through the Finance Bill for 2019. This transposition also repealed the *rabot* (25% haircut limitation), the Carrez Amendment, and the thin capitalization rules. In addition, A.T.A.D. 2 regarding G.A.A.R. and anti-hybrid rules were transposed in the F.T.C.

E.U. Member States were required to conform domestic legislation with the A.T.A.D. provisions by December 31, 2018. France has implemented comparable but not totally similar anti-abuse provisions regarding, *inter alia*, C.F.C. rules and exit taxation. A transitional extension is granted to E.U. Member States that have already implemented targeted rules for preventing B.E.P.S., provided those rules are equally effective as the A.T.A.D. provisions. France has taken advantage of this relief.

### **Proposal for A.T.A.D 3**

On December 22, 2021, the European Commission published a proposal for a directive<sup>61</sup> to harmonize minimal substance tests for holding companies within the E.U. The proposal defines minimum substance criteria for companies in its scope and creates reporting obligations and sanctions.

On January 17, 2023, the European Parliament made amendment proposals. As a next step, the E.U. Council will now have the final say on the A.T.A.D. 3 Directive's adoption.

Firstly, the E.U. set a very ambitious schedule with a deadline for transposition by Member States of June 30, 2023 and application from January 1, 2024. However,

<sup>59</sup> Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1.

<sup>60</sup> Council Directive 2017/952/E.U. Amending Directive 2016/1164/E.U. As Regards Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

<sup>61</sup> Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/E.U., December 22, 2021, COM (2021) 565 final.



*“The A.T.A.D. 3 Directive proposal provided that companies within the scope of the directive should be tagged as companies at risk.”*

as of this writing, no consensus has been reached and the Directive proposal may yet be withdrawn and replaced by a new one.

The A.T.A.D. 3 Directive proposal provided that companies within the scope of the directive should be tagged as companies at risk. This would apply to the following cases:

- More than 75% of the income derived by the company includes listed passive income.<sup>62</sup>
- More than 60% of the book value of company's immovable property or private movable property (of which the book value is higher than €1 million, other than cash, shares, or securities), is located outside of the Member State of its residence, or more than 60% of the income derived from listed passive income is cross-border income.
- The company outsourced the administration of day-to-day operations and decision-making on significant functions.

The directive would provide for specific exemptions.

The company at risk would have to declare in its annual tax return whether it meets the following indicators of minimum substance:

- Having its own premises or premises for its exclusive use in the Member State
- Having at least one owned and active bank account in the E.U.
- Having at least one qualified director residing in the Member State (or a border State) who regularly makes decisions relating to passive income, without being an employee or director of third-party companies

Where one of the indicators of minimum substance is not met, the company would be considered a “shell entity” unless it can demonstrate (i) the commercial rationale behind the establishment of the company, (ii) concrete evidence of local decision-making concerning the activity generating the income, and (iii) the actual activities of the employees and their qualifications.

The consequences of being considered a shell entity are (i) the elimination of tax advantages related to the establishment of the company in the source-income state and the beneficial owner state, (ii) the inability to obtain tax certificates for the benefits of tax treaties, and (iii) tax transparency treatment for the shell entity. Furthermore, information related to the shell entity's identification or exemption would be gathered in a central directory to which tax administrations would have to send information in the 30 days following the company's reporting obligation.

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<sup>62</sup> The list includes interest or other income generated from financial assets, including crypto assets, royalties, dividends and income from the disposal of shares; income from financial leasing; income from immovable property; income from movable property other than cash, shares, or securities held for private purposes and with a book value of more than €1 million; income from insurance, banking, and other financial activities; and income from services which the undertaking has outsourced to other associated enterprises.

Penalties for noncompliance may be include at least 5% of the shell company's turnover.

The proposal gives rise to many questions, especially in relation to the definition of the decision-making on significant functions for holding companies.

Information on companies within the scope of the directive, even those with sufficient substance, will be available to all Member States unless the company can justify that it provides no tax benefit to the U.B.O. and the group. The Member State that is the source country of any income or the residence country of the U.B.O. would not be deprived of the ability to apply their own G.A.A.R. or any other anti-abuse mechanisms.

# ITALY

## Author

Luca Rossi  
Facchini Rossi Michelutti  
Milan, Italy

## CORPORATE TAX RATE

As with any Italian-resident company, an Italian-resident holding company is subject to corporation income tax (“I.R.E.S.”) levied on the worldwide income of the company at a flat rate of 24%, as provided in the Income Tax Code (“I.T.C.”).<sup>1</sup>

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%.<sup>2</sup> 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 abovementioned rates.<sup>3</sup>

Starting from fiscal year 2020, a tax on digital services (“Web Tax”) was introduced by Article 1 (35) of Law n. 145 of December 30, 2018 further amended by Article 1 (678) of Law dated December 27, 2019 n. 160 and by Article 5 (15) of Law Decree dated March 22, 2021 n. 41.<sup>4</sup> The Web Tax is levied on revenues coming from the supply of certain digital services at the rate of 3% and it is applicable to enterprises which have realized, on a worldwide base, revenues of at least €750 million and, in Italy, revenues of at least €5.5 million coming from qualifying digital services.<sup>5</sup>

Starting in fiscal year 2018, a new definition of the term “holding company” was introduced in new Article 162-*bis* of I.T.C., introducing a distinction between financial holding companies and non-financial holding companies for I.R.E.S. and I.R.A.P. purposes.<sup>6</sup> According to Article 162-*bis* (3) of I.T.C., a holding company qualifies as industrial when its activity is mainly directed to the acquisition and managing of shareholdings in companies not qualifying as financial institutions. A holding is

<sup>1</sup> Presidential Decree dated December 22, 1986, n. 917. Pursuant to Article 1 (61-65) of Law n. 208 of December 28, 2015, as of 2017 (i) the corporation income tax rate has been reduced from 27.5% to 24% and (ii) a 3.5% surtax became applicable to banks and financial institutions (including holding companies of banks and financial institutions but excluding management companies of undertakings of collective investments).

<sup>2</sup> Legislative Decree n. 446 dated December 15, 1997.

<sup>3</sup> 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.

<sup>4</sup> Converted into Law n. 69 of May 21, 2021.

<sup>5</sup> The technical rules for the application of the Web Tax are set out in the Provision of the Director of the Italian Revenue Agency dated January 15, 2021.

<sup>6</sup> Article 162-*bis* of I.T.C. was introduced by Article 5 of Legislative Decree n. 142 of November 29, 2018, which implemented the Anti-Tax Avoidance Directive (E.U.) 2016/1164, as modified by Directive (E.U.) 2017/952 (hereinafter, the “A.T.A.D. Decree”).

deemed to carry on mainly such activity if the value of its shareholdings in companies other than banks and other financial institutions (plus the value of other assets connected with the same shareholdings such as credit granted to those subsidiaries) is more than 50% of the total asset value resulting from the latest approved financial statement.<sup>7</sup> A holding company that is legally classified as an Italian fixed capital investment company (*i.e.*, a *società di investimento a capitale fisso*, or “S.I.C.A.F.”) is subject to the tax regime applicable to undertakings for collective investment. See generally the discussion of collective investment vehicles, below, at **Tax Regime for Holding Companies Classified as S.I.C.A.F.’s**.

Article 6 of Legislative Decree n. 209 of December 27, 2023 (“International Taxation Decree”) introduced new tax benefits concerning the so-called “reshoring” of foreign activities. According to this provision, starting from fiscal year 2024, there is a 50% exemption on I.R.E.S. and I.R.A.P. for income derived from business activities that were previously carried out in a non-E.U./E.E.A. Member State that are transferred to Italy. The exemption applies for six tax years, including the tax year in which the transfer of activities to Italy occurs. Taxpayers are required to maintain separate accounting records to determine the income that qualifies for the exemption. The tax benefit is “recaptured” if some or all the activities are transferred out of Italy in the ten tax years following the reshoring (15 tax years for large enterprises).<sup>8</sup> The recapture occurs if even if the transfer of activities is to an E.U./E.E.A. Member State.

The transfer of activities to Italy may occur through any of the following transactions: (i) the migration of tax residence to Italy, (ii) a cross-border merger/demerger into a company resident in Italy, or (iii) the transfer of assets to an Italian branch of a company resident outside Italy. In these cases, the fair market value tax step-up of the assets (*e.g.*, I.P., goodwill) transferred to Italy also applies. Activities carried out in Italy in the 24 months preceding the transfer to Italy are not eligible.<sup>9</sup>

## GLOBAL MINIMUM TAX

Article 8 of the International Taxation Decree implemented Council Directive (E.U.) 2022/2523 of December 14, 2022, regarding a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the E.U. (“Pillar Two rules”) in Italy.

Pillar Two rules ensure a 15% minimum Effective Tax Rate (“E.T.R.”) for multinational and domestic groups with consolidated annual revenues of at least €750 million on income derived from each jurisdiction where the group operates. Where a constituent entity of the group is “low-taxed” (*i.e.*, subject to an E.T.R. below 15%, determined on a jurisdictional basis,), a “top-up” tax is collected through the application of the following:

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<sup>7</sup> As clarified by the Italian tax authority in Ruling Answer n. 40 of January 13, 2021, such an asset test should be computed with reference to the financial year coinciding with the tax period covered by the relevant tax return.

<sup>8</sup> According to the E.U. Commission Recommendation 2003/361/E.C., an enterprise is considered to be “large” if it employs more than 250 persons and has an annual turnover exceeding €50 million, or an annual balance sheet exceeding €43 million.

<sup>9</sup> Such provisions must be authorized by the E.U. Commission.

- The “qualified domestic minimum top-up tax” (“Q.D.M.T.T.”), which is due in Italy for low-taxed entities of the group located in Italy
- The “income inclusion rule” (“I.I.R.”), which is applied by Italian parent entities in relation to the top-up tax due on the low-taxed entities of the group not subject to a Q.D.M.T.T.
- The “undertaxed profits rule” (“U.T.P.R.”), which is applied by all the group entities located in Italy when neither the Q.D.M.T.T. nor the I.I.R. applies or does not ensure a 15% minimum E.T.R.

The I.I.R. and the Q.D.M.T.T. are applicable for tax years beginning on or after December 31, 2023, while the U.T.P.R. is applicable for tax years beginning on or after December 31, 2024.

The implementation of the Pillar Two rules is supplemented the Ministerial Decree of May 20, 2024, which eliminates the top-up tax in three circumstances:

- The first is that (i) the total income of the multinational group or the domestic group is below €10 million and (ii) the amount of profits before taxes is below €1 million or is negative.
- The second is that the tax rate applicable to the group as reported on its financial statements is not less than the specified rate, as follows:
  - 15% for tax year 2024
  - 16% for tax year 2025
  - 17% for tax year 2026
- The group ended the fiscal year with a loss (profit) before taxes which is equal to or less than the substance-based income exclusion amount, as calculated under Article 35 of the International Taxation Decree.

## 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 1.2%.<sup>10</sup> There are no minimum ownership or holding period requirements.

For companies adopting I.A.S./I.F.R.S. accounting principles, profits received from shares, or other financial assets qualifying as “held for trading” are fully taxable.<sup>11</sup> These companies must determine the positive and negative components of their tax base according to I.A.S./I.F.R.S. criteria, as the accounting standards prevail over the ordinary I.T.C. rules (known as the “Derivation Principle”).

<sup>10</sup> See Article 89(2) I.T.C. Pursuant to Article 1 (62) of Law n. 208 of December 28, 2015, as of 2017, the corporation income tax rate has been reduced from 27.5% to 24%. Therefore, the effective tax rate on dividends is 1.2% ( $0.05 \times 0.24 = 0.012$ ).

<sup>11</sup> See Article 89(2-bis) I.T.C.

When applying the Derivation Principle, the timing accrual principle and the qualification and classification criteria provided by the I.A.S./I.F.R.S. accounting methods are relevant in the calculation of the taxable base. The same principle does not apply to the evaluation and quantification criteria stated by the I.A.S./I.F.R.S. The Derivation Principle has also been extended to companies drawing up their financial statements pursuant to the Italian Civil Code and Italian generally accepted accounting principles (“G.A.A.P”), with few exceptions.<sup>12</sup>

### **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 its country of residence.<sup>13</sup> Nondeductibility must be stated by the foreign company in a declaration or must result from other objective evidence.

Dividends derived by Italian companies from subsidiaries resident in a country or territory characterized as having a privileged tax regime (a “Blacklist jurisdiction,” as defined) are fully taxable, unless income has been already taxed in the hands of the Italian recipient under the applicable controlled foreign corporation (“C.F.C.”) rules<sup>14</sup> or a favorable ruling is obtained from the Italian tax authorities, in which case no income is included (see below).

As of 2023, Article 1 (87–95) of Law n. 197 December 29, 2022 introduced an optional regime that allows Italian companies to exclude dividends distributed by foreign subsidiaries or permanent establishments subject to the branch exemption regime located in Blacklist jurisdictions<sup>15</sup> from their taxable income, paying a substitute tax at the rate of 9% on the profits. These earnings must come from the 2021 financial statements of the relevant subsidiaries or permanent establishments. Once a distribution occurs, a priority rule applies, according to which profits that were subject to the substitute tax are deemed to be received first. The substitute tax can be applied at a reduced rate of 6% if the Italian company will receive the foreign dividends by June 30, 2024 and the relevant profits will be set aside in a specific equity reserve for at least two years.

According to Article 47-*bis*,<sup>16</sup> a foreign tax regime – other than a tax regime of an E.U. Member State or an E.E.A. Member State that has signed an agreement with Italy allowing the effective exchange of information – is considered to be a Blacklist jurisdiction in one of two fact patterns:

- The first fact pattern relates to a C.F.C as defined below at **C.F.C. Legislation**. If the foreign company paying the dividend is a C.F.C., the foreign

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<sup>12</sup> See Article 83, I.T.C. as modified by Article 13-bis (2) of Decree n. 244 of December 30, 2016.

<sup>13</sup> Moreover, according to the Italian Revenue Agency, the profits must totally derive from the economic results of the issuer (see the Ruling Answer n. 256 of March 17, 2023, which confirmed the interpretation proposed in the Circular Letter n. 4/E of January 18, 2006).

<sup>14</sup> In this case, a foreign tax credit will be available for taxes paid on C.F.C. income.

<sup>15</sup> See **Branch Exemption Regime**.

<sup>16</sup> This Article was introduced by Article 5 of the A.T.A.D. Decree, and it entered into force in 2018.



country in which it is resident will be considered to be a Blacklisted jurisdiction if the C.F.C. is subject to an effective tax rate that is (i) below 15%, if the financial statement of the company is certified by authorized auditors in the foreign jurisdiction, or (ii) less than 50% of the effective tax rate which would be applicable if the same entity were resident in Italy for tax purposes.

- The second fact pattern relates to a foreign company that is not a C.F.C. Here, the foreign country will be considered to be a Blacklisted jurisdiction if the subsidiary is subject to a nominal income tax rate that is less than 50% of the applicable Italian tax rate, taking into account special tax regimes.

In case of a tax audit, the taxpayer must demonstrate that the investment was not made for the purpose of obtaining the benefits of a preferential tax regime. If the Italian corporation fails to demonstrate that the investment was not motivated by an intent to benefit from the preferential tax regime, it may be able to deduct 50% of the dividend provided it proves that the distributing company carries on a substantial economic activity supported by staff, equipment, assets, and premises.<sup>17</sup>

Taxpayers who have opted for the cooperative compliance regime provided by Articles 3-7 of the Legislative Decree n. 128 of August 5, 2015 (“Cooperative Regime”),<sup>18</sup> or taxpayers who have applied for the new investments ruling provided for by Article 2 of the Legislative Decree of September 14, 2015 (“New Investment Ruling”),<sup>19</sup> can submit an advance ruling request to demonstrate the abovementioned conditions have been met. Where an advance ruling has not been requested or a positive ruling is not obtained, dividends from entities resident in a Blacklisted jurisdiction must be disclosed on the relevant tax return.<sup>20</sup> Substantial penalties are imposed for a failure to disclose.

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. Again, see **C.F.C. Legislation** for a discussion of C.F.C. rules. Full taxation applies only to Blacklist dividends derived directly from a participation in a subsidiary that is resident in a Blacklist jurisdiction or through a C.F.C. in a non-Blacklist country that invests in Blacklist-resident participations.

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<sup>17</sup> In this case, a foreign tax credit is granted to the controlling company pursuant to 165 I.T.C., discussed below at **Foreign Tax Credit**. See Article 89(3) I.T.C., as substituted by Article 5 of Legislative Decree n. 142 of November 29, 2018.

<sup>18</sup> The Cooperative Regime is reserved for a limited number of taxpayers due to its stringent access requirements. It aims to promote enhanced cooperation between the Italian Tax Administration and taxpayers in order to increase the level of certainty on relevant tax issues, thereby preventing tax litigation.

<sup>19</sup> The New Investment Ruling enables resident and nonresident investors intending to make long lasting and relevant investments within Italy to obtain a preventive opinion from the Italian Revenue Agency on the tax treatment applicable to business plans and related extraordinary operations.

<sup>20</sup> See Article 89(3) I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015.



## 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. In principle, this means that any shares acquired within the period beginning 12 months prior to a share’s sale is deemed to be sold prior to shares held for 12 months or more.
- The participation must be classified as a fixed financial asset on the shareholder’s first balance sheet after the holding period begins for the shares.
- The subsidiary must be tax resident in Italy or in a country that is not a Blacklisted jurisdiction or territory, as described above at **Domestic Dividends** and **Foreign Dividends**. If the company is resident in a Blacklisted jurisdiction, the shareholder may attempt to demonstrate to the Italian tax authorities that the purpose of the investment was not to obtain the benefits of a preferential tax regime. Such condition must be continuously verified starting from the first period of ownership of the participation (or, starting from the fifth fiscal year preceding the disposal of the participation, where such disposal occurred in favor of third parties).<sup>21</sup> Taxpayers who have opted for the Cooperative Regime and taxpayers who have applied for the New Investment Ruling can present an advance ruling to demonstrate the fulfillment of the abovementioned conditions. Where an advance ruling has not been requested or a positive ruling was not obtained, capital gains from a company resident in a Blacklist jurisdiction must be disclosed on the Italian tax return.<sup>22</sup>
- The subsidiary must have been engaged in an active business for three or more years preceding the financial year of the sale, unless the 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 on an active business if real estate is the principal asset reported on its balance sheet. Where a subsidiary is a holding company, the tests regarding tax residence and business activity are applied at the level of the subsidiary operating companies. Where the participation exemption applies to a gain, only the portion of costs related to the taxable portion of the sale is deductible, *viz.*, 5%.

Article 1 (59) of the Law n. 213 of December 30, 2023 (“Budget Law for 2024”) extended the 95% participation exemption regime under Article 87 of the I.T.C. to

<sup>21</sup> See Article 87(2), as modified by Article 5 of the A.T.A.D.

<sup>22</sup> *Id.*, Article 87(1).

*“Under the anti-avoidance rules, a company is deemed not to be carrying on an active business if real estate is the principal asset reported on its balance sheet.”*

capital gains derived from the sale of qualified participations<sup>23</sup> in resident entities by nonresident entities without a permanent establishment in Italy. This rule applies to entities resident in an E.U. Member State or an E.E.A. country that allows an adequate exchange of information with Italy.



## INTEREST DEDUCTION

The A.T.A.D. Decree redefined the interest deduction regime for companies subject to I.R.E.S., starting from 2019.

The interest deduction regime, in general, provides as follows:<sup>24</sup>

- Interest expense is fully deductible against interest income in each tax period.
- The interest expense in excess of interest income results in net interest expense. The net 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.”). E.B.I.T.D.A. must be quantified on the basis of the relevant tax values, *i.e.*, reflecting the corporate income tax adjustments applied to E.B.I.T.D.A. computed for accounting purposes.
- The amount of interest expense that exceeds the 30% limit is 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.
- The excess of interest income over interest expense in a fiscal year may be carried forward and applied when determining net interest expense of following periods.
- The excess deduction capacity is the amount by which 30% of E.B.I.T.D.A. exceeds net interest expense. This capacity may be carried forward and used to increase the deduction capacity in the following five periods.<sup>25</sup>

Financial intermediaries such as banks and insurance companies and their holding companies and certain other financial institutions are excluded from the interest deduction limitation regime. Separate specific rules apply to banks and insurance companies. Under Article 162-bis (2) of I.T.C., a holding company qualifies as a financial intermediary when more than 50% of its total assets consist of investments in shares of other financial intermediaries and related assets such as intercompany receivables (see **Corporate Tax Rate**).

Consequently, the limitation regime applies to industrial holding companies that maintain participations in other entities that do not carry on lending activities or

<sup>23</sup> Pursuant to Article 67 (1) of the I.T.C., a participation is considered “qualified” in the following fact patterns: (i) the participation represents a greater than 25% interest in an unlisted company or a greater than 5% interest in a listed company or (ii) the participation represents more than 20% of the voting rights in an unlisted company or greater than 2% of the voting rights in a listed company.

<sup>24</sup> See *id.*, new Article 96.

<sup>25</sup> Specific grandfathering rules are provided with respect to deduction of interest of expense related to loans granted before June 17, 2016 (which are not subsequently modified).

financial services to the public.<sup>26</sup> Industrial holding companies that participate in a domestic consolidation for tax purposes in Italy may compute the ceiling for deductible interest expense based on 30% of the E.B.I.T.D.A. of the group, as discussed below at **Domestic Consolidation**. The carryforward of nondeductible interest expense is also computed on a consolidated basis if Italian corporate income tax is computed on a consolidated basis in the arising year and the carryforward year.

In the past few years, the deductibility of interest incurred in connection with merger or leveraged buyout acquisitions has been challenged by the Italian tax authorities based on anti-abuse rules or the assertion that the expense is not connected with the activities of the target. In Circular Letter n. 6/E of March 30, 2016, the Italian Revenue Agency clarified that, as a general principle, interest expense incurred on acquisition financing may be deductible in the following circumstances:

- The acquisition debt is functionally connected to the leveraged acquisition.
- The leveraged transaction is not considered abusive. This means that, based on specific circumstances, the debt was not incurred to obtain a tax advantage that is contrary to the spirit and objectives of the law. An example of an abusive transaction is a re-leveraging transaction after completion of the acquisition in the absence of a change of control over the target.<sup>27</sup>

## 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 n. 724 dated December 23, 1994, an entity is deemed to be a non-operating company when the sum of (i) its turnover, (ii) the increase in its inventory, and (iii) its revenue as reported on its profit and loss statement are below a specified base amount, which consists of the following three items:

- 2% of the total value of participations in resident and nonresident companies, bonds, other financial instruments, and financial credits
- 4% to 6% of the value of real estate and ships owned or leased by the company
- 15% of the value of other fixed assets

The calculation is made on the average values over a three-year period that includes the tax period concerned and the two preceding periods. Dividends are not considered as revenue and shareholdings in operating subsidiaries are excluded from the total value of participations.

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<sup>26</sup> *Id.*, Article 96 (12).

<sup>27</sup> See the Ruling Answers of the Italian Revenue Agency n. 142 of March 21, 2022, n. 395 of July 29, 2022 and n. 84 of January 19, 2023.

When a company is a non-operating company under the foregoing definition, it is taxed at a rate of 34.5% on minimum income.<sup>28</sup> Minimum income is calculated by applying a deemed return to the assets mentioned above. The deemed returns are the following:

- 1.50% of participations, other financial instruments, and financial credits
- 4.75% of real estate values (reduced to a 3% to 4% rate for residential real estate assets and offices)
- 12% of other fixed assets

Taxpayers who have opted for the Cooperative Regime and taxpayers who have applied for the New Investment Ruling may attempt to obtain an exemption from the minimum tax by demonstrating to the Italian tax authorities that specific facts and circumstances prevented it from achieving the minimum turnover. Where an advance ruling has not been requested or a positive ruling is not obtained, the taxpayer can disclose on its tax return the good faith reasons for failing to meet the minimum deemed returns.<sup>29</sup> Other taxpayers can demonstrate the circumstances during a tax audit.

Certain automatic exclusions from the scope of the general rule will apply if any of the following facts exist:

- The company is in the first year of activity.
- The shares of the company, its controlling shareholders, or one or more subsidiaries are traded on a stock exchange.
- The company had at least ten employees in the two preceding fiscal periods.
- The value of the company's production measured on the profit and loss statement is greater than the total value of assets reported on the balance sheet.
- The company is undergoing insolvency proceedings.<sup>30</sup>

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<sup>28</sup> A surtax of 10.5% is added to the 24% tax rate. See Article 2 (36-*quinquies*) of Decree Law n. 138 of August 13, 2011. Moreover, the V.A.T. credit related to a non-operating company cannot be refunded. In addition, if for three consecutive tax periods the non-operating company does not carry out any transaction that is relevant for V.A.T. purposes, the V.A.T. credit cannot be carried forward for offsetting V.A.T. payable in subsequent tax periods. The European Court of Justice, in its decision issued on March 7, 2024 (Case C-341/22), stated that the V.A.T. Directive must be interpreted as preventing national legislation from attempting to deny the status of a taxable person for V.A.T. purposes where that person carries out transactions that are subject to V.A.T. According to E.C.J., the right to deduct input V.A.T. may be denied only if fraud or abuse is proven by the member state.

<sup>29</sup> See Article 30 (4-*quater*) of Law n. 724/1994, as modified by Article 7 of Legislative Decree n. 156 of September 24, 2015.

<sup>30</sup> Article 9 (1) of Law Decree n. 73 of June 21, 2022, converted into Law n. 122 of August 4, 2022, repealed the provisions which provided the extension of the non-operating company regime to companies generating systematic tax losses.

## ALLOWANCE FOR CORPORATE EQUITY

Starting from fiscal year 2024, Article 5 of Budget Law for 2024 abrogated the Allowance for Corporate Equity (“A.C.E.”) deduction, but preserved the possibility to carry forward any excess from the A.C.E. deduction accumulated through 2023 without a time limit (as well as the I.R.A.P. tax credits, see below).

The A.C.E. deduction (in force until 2023) was introduced in order to encourage companies to strengthen their financial structure by using equity rather than debt. It allowed for a notional return on the increase in equity generated after 2010, which could be deducted from total net income if derived from capital contributions and the retention of earnings.<sup>31</sup>

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 it can be converted into a tax credit equal to 24% of the notional yield to offset (in five equal annual installments) the I.R.A.P. due for each tax year.

Ministerial Decree of August 3, 2017 (“Decree”) contains the operative provisions for computing the A.C.E. deduction. The benefit may be claimed by each of the following business enterprises:

- 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.
- Individuals, S.N.C.’s, and S.A.’s regulated by ordinary accounting rules

The 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.<sup>32</sup> From 2019, the rate is 1.3%.<sup>33</sup>

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

*“The A.C.E. deduction (in force until 2023) was introduced in order to encourage companies to strengthen their financial structure by using equity rather than debt.”*

<sup>31</sup> See Article 1 (2) of Law Decree n. 201 of December 6, 2011, as modified by Article 7 (1) of Law Decree n. 50 of April 24, 2017.

<sup>32</sup> The equity book value at the end of the year 2010 is computed without taking into account the profit of the year 2010.

<sup>33</sup> See Article 1 (287) of Law n. 160 of December 27, 2019.

- Income accumulated, with the exception of income accumulated in non-available reserves<sup>34</sup>

The net increase in any particular year cannot exceed the value of the net equity at the end of that year.<sup>35</sup> Moreover, for entities other than banks and insurance companies, the net increase must be reduced by an amount equal to the increase in value of non-equity securities (including shares in undertakings for collective investments) compared to their value as of December 31, 2010.<sup>36</sup>

In computing the net increase in equity, Article 5 (4) of the Decree provides that decreases in equity through any type of distribution to a shareholder must be taken into account. This rule covers dividend distributions and equity reductions.

Specific rules are provided for companies participating in a group consolidation<sup>37</sup> and for companies opting for the “transparency regime” under Articles 115 and 116 I.T.C.<sup>38</sup> Moreover, Article 10 of the Decree provides specific anti-avoidance rules that are directed at 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. Two consolidation regimes exist. One is known as the domestic consolidation regime,<sup>39</sup> and the other is the international or worldwide consolidation regime.<sup>40</sup>

### Domestic Consolidation

For the purpose of the domestic consolidation regime, a group of companies includes 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 more than 50% of the voting rights at the subsidiary’s general shareholders’ meeting. Second, the common parent must, directly or indirectly, be entitled to more than 50% of the subsidiary’s profits. The “de-multiplier effect” must be considered in both cases.

In certain 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, the foreign parent must carry out business activities in Italy through a permanent establishment.

<sup>34</sup> See *id.*, Article 5(6) for the definition of “non-available reserves.”

<sup>35</sup> *Id.*, Article 11. Such limitation is not applicable to capital increases carried out in 2021 up to the maximum amount of €5 million, according to Article 19 of Law Decree of May 21, 2021.

<sup>36</sup> See Article 1 (6-*bis*) of Law Decree n. 201 of December 6, 2011, as modified by Article 1 (550) of Law n. 232 of December 11, 2016, and Article 5 (3) of the Decree.

<sup>37</sup> See Article 6 of the Decree.

<sup>38</sup> *Id.*, Article 7.

<sup>39</sup> See Article 117-129, I.T.C.

<sup>40</sup> *Id.*, Article 130-142.

Legislative Decree n. 147 of September 14, 2015, introduced a “horizontal” tax consolidation regime. With effect from 2015, this regime allows a parent entity that is resident in an E.U. Member State or E.E.A. Member State that has signed an agreement with Italy allowing the effective exchange of information to designate an Italian-resident subsidiary or permanent establishment as a “consolidating” entity. The consolidating entity may then form a single fiscal unit with another direct or indirect subsidiary of the same parent company. Legislative Decree n. 147 also introduced legislation allowing Italian permanent establishments of E.U. and E.E.A. companies to be included in the fiscal unit as consolidated entities with other Italian-resident companies of the same group.

The domestic consolidation regime applies only 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 a separate company 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 each controlled subsidiary is considered 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, which is applicable to the ceiling imposed on interest expense. See above at **Interest Deduction**. 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. In order for a nonresident company to participate, its financial statements must be audited. Companies opting for the Cooperative Regime and companies applying for a New Investment Ruling can submit documentation to the Italian tax authorities verifying that the requirements to opt for the worldwide consolidation regime are effectively met.<sup>41</sup> Other taxpayers can demonstrate the fulfillment of the conditions during a tax audit.

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 in order to be effective. In addition, 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 by only a few Italian groups of companies.

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<sup>41</sup> *Id.*, Article 132 (3).

## C.F.C. LEGISLATION<sup>42</sup>

Profits realized by a C.F.C. are deemed to be the profits of an Italian company when all the following conditions are met:

- The resident company directly or indirectly controls the foreign company.
- At least one third of the revenue of the foreign company is passive income (as defined below).
- The foreign company is subject to an effective tax rate that is below 15%, calculated as the ratio between the company's current and deferred income taxes and its earnings before taxes ("Simplified Tax Rate Test"). The Simplified Tax Rate Test is applicable only if the financial statement of the company is certified by authorized auditors in the foreign jurisdiction. In all other cases, the company must verify whether the foreign subsidiary is subject to an effective tax rate lower than 50% of the effective tax rate which would be applicable if the same entity were resident in Italy.<sup>43</sup> This latter test also can be applied by the certified company as an alternative to the Simplified Tax Rate Test.

For purposes of the C.F.C. regime, a company may be deemed to be controlled in either of the following circumstances:

- The Italian resident maintains control of the foreign company as defined in Article 2359 of the Italian Civil Code, by (i) holding, directly or indirectly, the majority of the voting rights exercised at the general shareholders' meeting of the company or sufficient votes to exert a decisive influence in the shareholders' meeting of the company or (ii) having a dominant influence over the company due to contractual relationships.
- The Italian resident holds more than 50% of the profit rights of the foreign company directly, indirectly or by one or more companies controlled according to Article 2359 of the Italian Civil Code.

In addition, the following enterprises are considered controlled for C.F.C. purposes:

- A foreign permanent establishment of a C.F.C.
- A foreign permanent establishment of a resident company which opted for the branch exemption regime that is discussed below at **Branch Exemption Regime**



<sup>42</sup> *Id.*, Article 167, as modified by Article 4 of the A.T.A.D. (the main changes introduced by this provision are clarified in the Circular Letters n. 18/E of December 27, 2021 and n. 29/E of July 28, 2022, issued by the Italian Revenue Agency; they provide detailed guidance regarding the scope of the C.F.C. rules, the control requirement, the level of taxation requirement, and the determination, allocation, and taxation of the C.F.C. income) and more recently by Article 3 of the International Taxation Decree which aligned the C.F.C. rules with the Pillar Two rules.

<sup>43</sup> The Provision of the Director of the Italian Revenue Agency dated December 27, 2021, which replaced the previous Provision dated September 16, 2016, contains the criteria for determining the effective level of taxation of the C.F.C.



The following types of revenue are deemed to be passive income:

- Interest or any other income deriving from financial assets
- Royalties or any other income arising from intellectual property
- Dividends and income deriving from the disposal of shares
- Income from financial leasing
- Income derived from insurance, banking and other financial activities
- Revenues derived from sales of low-value goods and supply of low-value services, carried out with associated companies

In order to avoid the application of the C.F.C. regime, Italian-resident companies which have opted for the Cooperative Regime or applied for the New Investment Ruling may attempt to obtain a ruling from the Italian tax authorities that the non-resident company carries out a substantial economic activity supported by staff, equipment, assets, and premises. Where an advance ruling has not been requested or a positive ruling is not obtained, the existence of C.F.C. subsidiaries must be disclosed on the relevant tax return. Other taxpayers can demonstrate the above-mentioned circumstances during a tax audit.

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 attributed *pro rata* by reference to the profit participation rights held by the Italian company that maintains control and are taxed separately at the average tax rate for Italian-resident corporations, which is 24%.

Italian law provides for the concept of previously taxed income. When profits that were previously attributed to an Italian resident company are distributed in the form of dividends, the dividends are not treated as taxable income.

As an alternative, starting from fiscal year 2024, according to the provisions introduced by Article 3 of the International Taxation Decree, if a C.F.C.'s financial statement is audited, the controlling company may opt for the payment of the 15% substitutive tax on the net income before taxes of the C.F.C., without considering asset write-offs and risk provisions. The option is effective for three fiscal years and cannot be revoked.<sup>44</sup>

## TREATY PROTECTION

Italy has income tax treaties in effect with over 90 jurisdictions, including many 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. A notable exception exists for withholding tax on interest. In the current treaty with the U.S., the withholding tax rate on interest income is 10%, which is problematic for many groups.

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<sup>44</sup> *Id.*, Article 167 (4-ter) (4-*quater*) of I.T.C. The Provision of the Director of the Italian Revenue Agency dated April 30, 2024, n. 213637, contains the methods for implementation of the 15% substitutive tax.

Listed below are the jurisdictions that have income tax treaties with Italy that are currently in force and effect:

|                      |             |              |                      |
|----------------------|-------------|--------------|----------------------|
| Albania              | Ethiopia    | Malta        | Slovakia             |
| Algeria              | Finland     | Mauritius    | Slovenia             |
| Argentina            | France      | Mexico       | South Africa         |
| Armenia              | Georgia     | Moldova      | South Korea          |
| Australia            | Germany     | Mongolia     | Spain                |
| Austria              | Ghana       | Montenegro   | Sri Lanka            |
| Azerbaijan           | Greece      | Morocco      | Sweden               |
| Bangladesh           | Hong Kong   | Mozambique   | Switzerland          |
| Barbados             | Hungary     | Netherlands  | Syria                |
| Belarus              | Iceland     | New Zealand  | Taiwan               |
| Belgium              | India       | Malaysia     | Tajikistan           |
| Bosnia & Herzegovina | Indonesia   | Norway       | Tanzania             |
| Brazil               | Ireland     | Oman         | Thailand             |
| Bulgaria             | Israel      | Pakistan     | Trinidad & Tobago    |
| Canada               | Ivory Coast | Panama       | Tunisia              |
| Chile                | Jamaica     | Philippines  | Turkey               |
| China                | Japan       | Poland       | Uganda               |
| Colombia             | Jordan      | Portugal     | Ukraine              |
| Congo (Rep.)         | Kazakhstan  | Qatar        | United Arab Emirates |
| Croatia              | Kyrgyzstan  | Romania      | United Kingdom       |
| Cyprus               | Kuwait      | Russia       | United States        |
| Czech Republic       | Latvia      | San Marino   | Uruguay              |
| Denmark              | Lebanon     | Saudi Arabia | Uzbekistan           |
| Ecuador              | Lithuania   | Senegal      | Venezuela            |
| Egypt                | Luxembourg  | Serbia       | Vietnam              |
| Estonia              | Macedonia   | Singapore    | Zambia               |

Italy has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

## WITHHOLDING TAXES ON OUTBOUND PAYMENTS

### **Dividend Withholding – Domestic Law**

In general, Italian domestic tax law provides that dividends distributed by Italian companies to nonresident persons are subject to a 26% withholding tax pursuant to Article 27 of Presidential Decree n. 600/1973. The recipient can claim a refund of up to eleven twenty-sixths of the withholding tax incurred when taxes have been paid on the same income in its country of residence.<sup>45</sup> This results in a net tax of 15% after receipt of the refund. Starting from 2021, dividend distributed to certain

<sup>45</sup> See Article 27 (3) of Presidential Decree September 29, 1973 n. 600.

nonresident funds are not subject to withholding tax.<sup>46</sup> It does not matter whether the fund is compliant with Directive 2009/65/E.U. Rather, the key factor is that the fund is established in an E.U. Member State or E.E.A. Member State allowing for an adequate exchange of information for tax purposes and whose manager is subject to regulatory supervision in the country where it is established pursuant to Directive 2011/61/E.U. Dividends paid out to pension funds established in E.U. or E.E.A. Member States listed in Ministerial Decree September 4, 1996 are subject to 11% withholding tax.<sup>47</sup>

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. or E.E.A. Member States included on the abovementioned list, a reduced 1.2% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions made to domestic companies as discussed above at **Dividend Exemption**. If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are entitled to a 95% exemption, as discussed above.

### **Parent-Subsidiary Directive**

Under the Parent-Subsidiary Directive (the “P.S.D.”) as implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may claim a refund for the 26% or 1.2% for withholding tax actually withheld on dividends distributed by Italian subsidiaries. After the amendments enacted by Directive

*“If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.”*

<sup>46</sup> See Article 1 (631-633) of Law n. 178 of December 30, 2020, which modified the abovementioned Article 27 of Presidential Decree September 29, 1973 n. 600. The amendment has been introduced in order to eliminate a discrimination between Italian and foreign investment funds. Since the scope of Article 63 T.F.E.U. on the free movement of capital extends also to third Countries, in order to fully comply with E.U. law, exemption from taxation at source should be eliminated also in respect of dividend received by non-E.U. investment funds provided that the relevant management company is subject to supervision and the fund is established in country which allows an adequate exchange of information with Italy so that the Italian tax authorities are able to verify that the fund is subject to a prudential supervision similar to that provided for by E.U. law under A.I.F.M.D. In this regard, the European Court of Justice stated that the principle of free movement of capital pursuant to Article 63 of the T.F.U.E. “*must be interpreted as precluding a Member State’s legislation under which dividends distributed by resident companies to a non-resident collective investment undertaking (U.C.I.) are subject to a withholding tax, while dividends distributed to a resident U.C.I. are exempt from such withholding tax*” regardless of whether the recipient of the dividend is an E.U. or non-E.U. U.C.I. (see the decision relating to case C-545/19 dated March 17, 2022).

Even though the new provisions are effective in respect to dividends paid from January 1, 2021, in case of conflict, based on the supremacy of E.U. law over national law, Member States should eliminate domestic provisions which infringe on E.U. law retrospectively (therefore, the new provisions should also be extended to dividends paid before 2021; such position was confirmed by the Italian Supreme Court in Decisions nn. 21454, 21475, 21480, 21481 and 21482 dated July 6, 2022, which also stated that the same principle should be extended to non-E.U. funds).

<sup>47</sup> Iceland, Liechtenstein, and Norway.

2003/123/C.E.,<sup>48</sup> 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 P.S.D., certain requirements must be met:

- The parent company must have one of the corporate forms listed in the P.S.D.
- The parent company must reside for tax purposes in an E.U. Member State.<sup>49</sup> 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.
- The parent company must be subject to one of the income tax regimes listed in the P.S.D. without the possibility of opting for favorable regimes or exemptions.
- The parent 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.

The general anti-abuse rule (“G.A.A.R.”) applies when determining if a parent company is entitled to the P.S.D. An E.U. parent may not benefit from an exemption arising from holdings that are shown to be artificial or that have been established with the sole or primary purpose of taking advantage of the exemption.<sup>50</sup>

As clarified in Circular Letter n. 6/E of March 30, 2016, related to leveraged buy-out transactions, with reference to G.A.A.R., an intermediate entity is deemed to have been set up merely as a conduit entity or as a part of a conduit arrangement in either of the following fact patterns apply to the intermediary:

- The intermediary entity has a light organization and does not carry out real economic activity or has little or no discretion in the decision-making process so that it may be viewed to be a conduit entity. A light organization exists where employees, offices, and equipment of the intermediary are made available by third-party service providers through management service agreements.
- The intermediary entity acts merely as a financial conduit in the context of a specific arrangement such as inbound and outbound payments that are symmetrical in term of amount, and maturity. In this way, the function of the intermediary entity allows payments to flow through without incurring an additional tax burden because payments made by the intermediary entity are not subject to further withholding tax. It thus serves as a conduit arrangement.<sup>51</sup>

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<sup>48</sup> Implemented in Italy by Legislative Decree dated February 6, 2007, n. 49. Article 27-*bis* of Presidential Decree n. 600/1973.

<sup>49</sup> Following the U.K.’s exit from E.U., starting from 2021 U.K. companies will no longer benefit from Parent-Subsidiary Directive.

<sup>50</sup> See the last paragraph of Article 27-*bis* of Presidential Decree n. 600/1973.

<sup>51</sup> See Circular Letter n. 6/E, issued by the Italian Revenue Agency on March 30, 2016.

## **Interest and Royalties**

### **In General**

Italy has implemented the Interest and Royalties Directive (“I.R.D.”) providing for a withholding exemption on payments of interest and royalties made to associated companies resident in E.U. Member States.<sup>52</sup> 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 the P.S.D. Annex B, and (b) has one of the corporate forms listed in the P.S.D. Annex A. 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. In all instances where benefits of the I.R.D. are claimed, the nonresident recipient must be the beneficial owner of the payments.<sup>53</sup>

For the purposes of the I.R.D., two companies are deemed to be associated under one of two tests.

- The first test is that one of the companies directly holds 25% or more of the voting rights at the general shareholders’ meeting of the other company. It does not matter which of the payor or recipient holds the requisite shares of the other company.
- The second test is that a third company, resident in a Member State and having one of the corporate forms listed in P.S.D. Annex A, directly holds 25% or more of the voting rights in the payor and the recipient companies.

No matter which test is applicable, the requisite ownership must be held for at least one year as of the date of the payment.

### **Intra-Group Interest Payments in the Context of Group-Issued Bonds**

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 when all the following conditions are met:

- The recipient is subject to one of the taxes listed in the P.S.D. and has one of the listed corporate form, as previously described.
- The interest payment is intended to finance the payment of interest and other proceeds on bonds issued by the recipient.
- The bonds are traded on an E.U.- or E.E.A.-regulated market.
- The bonds are guaranteed by the company paying the interest, its holding company, or a subsidiary.<sup>54</sup>

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<sup>52</sup> See Article 26-*quater*, Presidential Decree n. 600/1973. Following the U.K.’s exit from E.U., U.K. companies will no longer benefit from the I.R.D.

<sup>53</sup> For the definition of “beneficial owner” see *id.*, Article 26-*quater* (4).

<sup>54</sup> For more details, see *id.*, Article 26-*quater* (8-bis).

### Danish Cases

In the so-called Danish Cases, the European Court of Justice (“E.C.J.”) issued its judgments in joined cases C-115/16, C-118/16, C-119/16 and C-299/16 and in joined cases C-116/16 and C-117/16, respectively concerning the Interest and Royalty Directive and the P.S.D. The question submitted to the E.C.J. was whether dividend and interest payments were exempt from withholding tax when the payment was made to an E.U. company that subsequently passed the income to an ultimate parent company resident in a third country outside the E.U.

The E.C.J. first stated that based on the general principle of E.U. law, that E.U. law cannot be relied on for abusive or fraudulent ends. Exemption from withholding will be denied if the transaction has been put in place with the essential aim of benefiting from tax advantages, even if that is not the exclusive aim.

The E.C.J. went on to provide guidance to be used when assessing the existence of abuse in case of intermediary holding companies. Under that guidance, an arrangement may be considered as artificial in the following cases:

- Very soon after their receipt of dividends, the recipient passes all or almost all of the dividends to entities that do not fulfill the conditions for the application of the P.S.D. or the I.R.D. In this respect it is not necessary for the receiving company to have a contractual or legal obligation to pass the dividends, interest, or royalties to a third party. It may be sufficient to demonstrate based on the factual circumstances that the company does not have the right to enjoy the income received because *de facto* it acts as a conduit company.
- The intermediary company makes only an insignificant taxable profit, considering it must transfer the dividend, interest, or royalties to another company.
- The intermediate holding company lacks economic substance and carries out very limited activities. In the opinion of the E.C.J.:

[The] absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has.

In order to establish the existence of an abuse, the indicia referred above must be objective and consistent. Therefore, it could be argued that a single element, on a stand-alone basis, should not be sufficient to demonstrate the abusive character of the operation. However, the E.C.J. further stated that when the beneficial owner of dividends, interest, or royalties paid is resident for tax purposes in a third state, exemption may be refused regardless of the existence of an abusive practice.

### Withholding Tax on Medium-Long Term Loans

Pursuant to Article 26 (5) of Presidential Decree 600/1973, interest payments made to lenders not resident in Italy are subject to a final withholding tax at a rate of 26%. Double taxation treaties in force between Italy and the lender’s country of residence may apply, allowing for a lower withholding tax rate (generally 10%), subject to



compliance with relevant subjective and procedural requirements. Nonetheless, according to paragraph 5-*bis*<sup>55</sup> of the same Article, final withholding tax does not apply to interest payments on medium-long term loans<sup>56</sup> granted to commercial entities by any of the following entities:

- Credit institutions established in E.U. Member States
- Insurance companies incorporated and authorized under the law of E.U. Member State
- Foreign institutional investors, regardless their tax status, established in Whitelisted jurisdictions and subject to regulatory supervision therein
- Certain nonbanking, state-owned entities such as the U.K. National Savings Bank

The foregoing exemption is available only when the laws governing lending activities to the public are not infringed. Therefore, to benefit from the exemption, the lender must comply with all of the regulatory requirements for lending to the public.

In case facilities are partially or totally funded by back-to-back or other similar risk sharing agreements entered into between the fronting lender and the participants, payment of interest under the facilities will be subject to withholding tax depending on the status of the participant that is the beneficial owner of a particular interest in the loan, while the fronting lender will be disregarded, save for that part of the financing which has been funded by the fronting lender with its own financial resources.<sup>57</sup> Consequently, the borrower will make interest payments without tax deduction to the extent that the relevant participant meets and properly communicates the conditions requested to benefit from the withholding tax exemption pursuant to Article 26(5-*bis*) Presidential Decree 600/1973 and that the participant complies with the regulatory provisions on reserved banking or lending activities.

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<sup>55</sup> Introduced by Article 22 (1) of Law Decree n. 91 of June 24, 2014.

<sup>56</sup> Medium-long term loans are loans that (i) have a contractual duration of more than 18 months and one day and (ii) do not provide a prepayment option.

<sup>57</sup> Such reasoning, according to which Article 26 (5-*bis*) of Presidential Decree n. 600/1973 should apply based on the identity of the ultimate beneficial owner of the interest, has been partially contradicted by the Italian tax authority in Ruling Answer n. 423 of 23 October 2019 and Ruling Answer n. 125 of 24 February 2021 (as well as in another unofficial ruling) where it was stated that an exemption cannot be extended to the beneficial owner of the interest that is not the direct “recipient” of the interest. In particular, the Italian tax authority denied exemption on interest paid to a non-E.U. associated company although the loan granted by the associated company was financed through a back-to-back loan granted by an E.U. bank and therefore interest paid by the Italian borrower was indirectly received by an entity falling within the scope of Article 26 (5-*bis*) of Presidential Decree n. 600/1973. However, one opinion is that such clarification cannot be interpreted in the sense that the exemption applies irrespective of the identity of the beneficial owner of the interest (in this respect, please consider that in the abovementioned Ruling Answer No. 125, the Italian tax authorities stated that Article 26(5-*bis*) of Decree N. 600/1973 cannot apply if the beneficial owner of interest does not “*also*” qualify as the relevant direct recipient). Indeed, if interest paid to a lender which qualifies for exemption under Article 26 (5-*bis*) of Decree N. 600/1973 are passed to a sub-participant which does not qualify for the exemption, the structure could be challenged based on the anti-abuse principle.

In a criminal case (Case n. 12777/2019), the Italian Supreme Court addressed a fact pattern in which a fronting Italian licensed bank granted loans to Italian customers using the funds made available by a foreign bank based on an undisclosed mandate. The Supreme Court held there to be a breach of the regulatory prohibition of financial operations in the absence of authorization. Based on the court reasoning, even though the financing relationship was structured based on two separate contracts, for the purpose of the regulatory restrictions on lending, the concrete substance of the transaction prevailed over the legal form. In reaching that conclusion, the court adopted a list of criteria that should be considered when determining if the financing was actually granted by the foreign bank and that the legal structure hid the real activity carried out by the foreign non-licensed bank. The list of criteria is as follows:

- The sharing of the insolvency risk between the fronting lender and the foreign bank
- The independent assessment of customers' credit standing by the foreign bank
- The acknowledgment by the customers of the involvement of the foreign bank by signing the inter-creditor agreement with the latter
- The right of the foreign bank to be informed and to approve all circumstances that may affect the borrower's credit rating
- The fact that the commitment of the foreign bank exceeds the commitment of the fronting lender
- The fact that the fronting bank reported to the Italian Central Risk Data Base only its own exposure and not the overall amount of the loan

The court also observed that from a purely legal point of view, the undisclosed mandate provided the principal with some rights of action against the customers of the fronting institution, thus confirming that in substance the principal was the real lender.<sup>58</sup> In sum, the fronting institution acted more as an agent than a principal in the way it interfaced with borrowers and the regulatory agencies. The sub-participant that was not allowed to conduct direct lending activities in Italy could not benefit from exemption under Article 26(5-bis) Presidential Decree 600/1973.

### **Shell Entities**

On December 22, 2021, the European Commission issued a directive proposal aimed at ensuring that undertakings lacking minimal substance are not used as instruments of tax evasion or tax avoidance (hereinafter, the "Directive Proposal").

In general terms, the Directive Proposal provides indicators of minimum substance for undertakings in Member States and sets rules regarding the tax treatment of those entities that do not meet the indicators.

Undertakings that are presumed to be shell entities have the opportunity to rebut the presumption by demonstrating that they have substance or, in any case, that they are not misused for tax purposes. This is achieved by providing factual evidence of

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<sup>58</sup> The inter-creditor agreement provided the principal with rights of direct action against the customers.



their activities and the manner in which they carry them out. An undertaking that is presumed to be a shell entity would not be able to access tax relief and benefits of the tax treaty network of its Member State and/or to qualify for the treatment under the E.U. Directives, such as the P.S.D. and the I.R.D. (see **Parent-Subsidiary Directive** and **Interest and Royalties** above).

The Directive Proposal provides for an automatic exchange of information on all entities within the scope of the Directive Proposal, regardless of whether these are shell entities or not. Moreover, the Directive Proposal enables Member States to request that another Member State conduct a tax audit if they have doubts on whether or not an entity has a minimal substance. The Member State receiving such a request is expected to perform the tax audit and communicate the outcome to the former Member State in a reasonable time frame.

The Directive Proposal, once adopted as a Directive, should be transposed into Member States' national law by June 30, 2023 and come into effect as of January 1, 2024. The timeframe for adoption and transposition have been postponed.

### **Nonresident Company with a Permanent Establishment**

Companies with a permanent establishment<sup>59</sup> in Italy are taxed on the income of the permanent establishment. Permanent establishment income is determined under the rules applicable to income of resident companies, including the participation exemption regime discussed above in **Dividend Exemption** and **Participation Exemption for Gains**.

Pursuant to Article 152(2) I.T.C., replaced by Article 7(3) of Legislative Decree n. 147 of September 14, 2015 (the "International Tax Decree"), Italy applies the O.E.C.D.'s functionally separate entity approach when determining permanent establishment income. According to this methodology, income attributed to the permanent establishment will reflect an arm's length amount, *i.e.*, the amount the permanent establishment would have earned if it were a separate and independent enterprise engaged in comparable activities under comparable conditions. This arm's length amount should account for the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment.

Article 152(2) also provides that adequate free capital must be attributed to the permanent establishment for tax purposes. Again, the amount is determined based on O.E.C.D. principles, by considering the functions performed, assets used, and risks assumed by the permanent establishment.

### **Nonresident Company with 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.<sup>60</sup>



<sup>59</sup> The definition of permanent establishment is contained in Article 162 of I.T.C. The provision was recently modified by Article 1 (255) of Law n. 197 of December 29, 2022, which introduced the "Investment Management Exemption" regime, providing the conditions under which investment funds and investors can avoid being considered to have a permanent establishment in Italy due to the activities carried out by managers.

<sup>60</sup> See Article 151 (3), I.T.C.

*“A participation in a listed company is deemed to be qualified if the total interest sold during a 12-month period is greater than 2% of the company’s voting rights or 5% of the capital of the listed company.”*

Due to the changes introduced by the Budget Law for 2018,<sup>61</sup> as of January 1, 2019,<sup>62</sup> capital gains realized by foreign corporations upon the disposal of an interest in an Italian subsidiary are subject to a 26% substitute tax<sup>63</sup> regardless of the size of the participation.

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.<sup>64</sup> 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.<sup>65</sup>

A participation in a listed company is deemed to be qualified if the total interest sold during a 12-month period 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 interest sold during a 12-month period is greater than 20% of the company’s voting rights or 25% of the capital of the company.

These rules are subject to modification under an applicable treaty.

## BRANCH EXEMPTION REGIME

The International Tax Decree introduced the branch exemption regime.<sup>66</sup> As of 2016, an Italian resident company may be exempt from Italian tax on income and losses arising from foreign permanent establishments.

The election of exempt treatment is irrevocable and all-in/all out – it is applicable to all or none of the qualified existing permanent establishments. Branches falling within the scope of the C.F.C. rules will not qualify unless the condition for C.F.C. exemption is met, as discussed above at **C.F.C. Legislation**.

A loss recapture provision applies if the branch has incurred a net tax loss over the five-year period prior to the election. In this case, branch income will be included in the taxable basis of the Italian parent company, up to the amount of the pre-existing tax losses, with a corresponding foreign tax credit.

## FOREIGN TAX CREDIT

A foreign tax credit is granted to avoid international double taxation.<sup>67</sup> The tax credit limitation is calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period.<sup>68</sup>

<sup>61</sup> See Article 1 (999) of Law n. 205 of December 27, 2017.

<sup>62</sup> *Id.*, Article 1 (1005).

<sup>63</sup> See Article 5 (2) of Legislative Decree n. 461 of November 21, 1997.

<sup>64</sup> See Article 23 (1) (f) I.T.C.

<sup>65</sup> See Article 5 (5) (a), Legislative Decree n. 461/1997.

<sup>66</sup> See new Article 168-ter I.T.C., introduced by Article 14 of Legislative Decree n. 147/2015.

<sup>67</sup> See Article 165, I.T.C.

<sup>68</sup> *Id.*, Article 165 (6).

## TRANSFER PRICING

The Italian transfer pricing regime appears in Article 110 (7) I.T.C. and Ministerial Decree of May 14, 2018. The guidelines for the application of these provisions reflect the latest developments as outlined in the B.E.P.S. Report on Action Items 8, 9 and 10.

Pursuant to Article 110 (7),<sup>69</sup> business income of an Italian-resident enterprise is assessed on the basis of conditions and prices that would be agreed upon by independent parties operating at arm's length conditions and in comparable circumstances when the transaction involves (i) a nonresident company<sup>70</sup> that is directly or indirectly controlled by the Italian enterprise, (ii) a nonresident company that controls the Italian company, or (iii) a resident company and a nonresident company that are under the common control of a third company.

Following certain amendments,<sup>71</sup> Article 110 (7) no longer refers to the normal value of goods and services as defined in Article 9 (3) I.T.C. as a criterion for determining intercompany transfer prices. It now refers instead to the arm's length value, which can be compared to the arm's length value as defined by the O.E.C.D. Transfer Pricing Guidelines<sup>72</sup> and the O.E.C.D. Model Convention.

Article 110 (7) as revised further states that the application of the arm's length principle<sup>73</sup> applies in the case of both upward and downward adjustments in taxable income. Downward adjustments in taxable income may result from any of the following:

- Binding agreements concluded with the competent authorities of a Contracting State pursuant to a mutual agreement procedure provided for by a double tax treaty or E.U. Directive 90/436 (the "Arbitration Convention")
- The completion of tax audits carried out in accordance with the Convention on Mutual Administrative Assistance in Tax Matters
- Rulings for a downward adjustment in an intercompany transfer price requested by an Italian taxpayer after the tax authorities of a country having in effect an income tax treaty with Italy ("Contracting State") proposes a downward adjustment in the transfer price charged by an Italian company to an affiliate resident in the Contracting State. The relevant income tax treaty must contain provisions for exchanges of information and mutual agreement procedures in cross border transfer pricing matters. In this fact pattern, the taxpayer has a right to request the elimination of double taxation under the mutual agreement procedure of the applicable income tax treaty or the Arbitration Convention remain unchanged<sup>73</sup>

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<sup>69</sup> As amended by Article 59 of Law Decree n. 50 of April 24, 2017.

<sup>70</sup> In this regard, Article 5 (2) of Legislative Decree n. 147/2015 clarifies that the arm's length rule is not applicable to transactions between resident enterprises.

<sup>71</sup> See Article 59 of Law Decree n. 50 of April 24, 2017.

<sup>72</sup> As approved by the O.E.C.D. Council on July 10, 2017 and updated by the Transfer Pricing Guidelines dated January 20, 2022.

<sup>73</sup> In this respect, it should be noted that Legislative Decree n. 49 of June 10, 2020 recently implemented the Council Directive (E.U.) 2017/1852 on tax dispute resolution mechanism also provided for transfer pricing purposes.



Legislative Decree 78 of May 31, 2010, introduced Italian regulations for intercompany transfer pricing documentation. Although such documentation is not mandatory, this decree waives the application of administrative penalties if the taxpayer provides the relevant transfer pricing documentation to the tax authorities during a tax audit. Without the waiver, the penalties range from 90% to 180% of the tax assessed.

On November 23, 2020, the Italian tax authority introduced new provisions for intercompany transfer pricing documentation<sup>74</sup> with the aim of aligning the Italian transfer pricing regime to the international guidance provided by the O.E.C.D.<sup>75</sup>

Over the past few years, the Italian tax authorities have paid increasing attention to intra-group transactions during tax audits, resulting in an increase in the number of audits of intra-group transactions between members of multinational groups. As part of the importance given to transfer pricing by the Italian tax authorities, an active unilateral and bilateral advance pricing agreement program is in place for Italian based multinationals and their foreign affiliates.

## NEW PATENT BOX REGIME

Article 6 of Law Decree n. 146 of October 21, 2021<sup>76</sup> replaced the Patent Box regime introduced by Article 1 of Law n. 190 of December 23, 2014<sup>77</sup> with a new optional regime consisting of the super-deduction of 110% of costs incurred for R&D activities (development, enhancement, maintenance, protection, and exploitation) in relation to copyrighted software, patents, designs, and models.<sup>78</sup> Compared with the previous Patent Box regime, trademarks and know-how have been excluded from the list of eligible assets.

The new Patent Box regime requires an irrevocable option of five years (with the possibility to renew) to be made in the tax return related to the fiscal year in which the Patent Box regime applies.

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<sup>74</sup> See the Provision issued by the Director of the Italian Revenue Agency, of November 23, 2020, which substituted the previous Provision of September 29, 2010, and the Circular Letter n. 15/E, issued by the Italian Revenue Agency on November 26, 2021.

<sup>75</sup> O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, of July 10, 2017 updated by the Transfer Pricing Guidelines dated January 20, 2022.

<sup>76</sup> Converted into Law December 17, 2021, n. 215, as subsequently amended by Law December 30, 2021 n. 234.

<sup>77</sup> The “old” Patent Box regime granted a 50% exemption from I.R.E.S. and I.R.A.P. on income derived from the direct exploitation of certain intangible assets, such as patents, copyright protected software, and other intellectual property (“I.P. assets”) by resident companies and individual entrepreneurs or residents of treaty countries having an adequate exchange of information.

<sup>78</sup> The implementation rules for the new Patent Box regime are contained in the Provision of the Director of the Italian Revenue Agency dated February 15, 2022. The Circular Letter n. 5/E of February 24, 2023 issued by the Italian Revenue Agency contains explanations concerning the application of the new Patent Box regime.

The Law Decree waives the application of administrative penalties if the taxpayer provides the relevant explanatory documentation regarding qualifying R&D activities performed and expenses incurred. Such documentation must be digitally signed within the date of presentation of the tax return.

The new Patent Box regime is applicable as of fiscal year 2021. Taxpayers who opted for the previous Patent Box regime may continue to benefit from the old regime until the completion of the five-year term.

## AUTOMATIC EXCHANGE OF INFORMATION

Italy supports the Automatic Exchange of Information (“A.E.O.I.”) for tax purposes and is actively involved in implementing A.E.O.I. within the E.U. and O.E.C.D., and on a bilateral basis.

On January 10, 2014, the U.S. and Italy signed an intergovernmental agreement (“I.G.A.”) to implement the Foreign Account Tax Compliance Act (“F.A.T.C.A.”) regime. The I.G.A. was then ratified and enacted in Italy by Law n. 95 of June 18, 2015, Ministerial Decree of August 6, 2015 and the Provisions of the Director of the Italian Revenue Agency dated August 7, 2015, and April 28, 2016, provided the technical rules for the collection and the communication of the requested information.

In accordance with the F.A.T.C.A. rules, the Italian legislation provides, in brief, for A.E.O.I. as follows:

- Italy will engage in bilateral exchanges of information with the U.S. in relation to accounts held in Italian financial institutions by U.S. persons.
- Financial institutions must forward specified information to the Italian tax authorities, which will transmit the data to the I.R.S.
- If certain conditions are met, holding companies may be subject to the F.A.T.C.A. reporting regime.

Similar reporting requirements have recently been introduced for countries other than U.S. The Common Reporting Standard (“C.R.S.”) and Directive 2014/107/E.U.<sup>79</sup> (“D.A.C.2”), regarding A.E.O.I. between tax authorities, are applicable in Italy. These rules were implemented in Italy by Law n. 95 of June 18, 2015, and enacted by Ministerial Decree dated December 28, 2015.<sup>80</sup>

Italian implementation of F.A.T.C.A., C.R.S., and D.A.C.2 is intended to prevent tax evasion by foreign individuals who maintain financial relationships with Italian financial institutions. In particular, these regulations require Italian financial institutions to identify their customers in accordance with specific criteria and to communicate certain information to relevant tax authorities abroad regarding (i) interest income, dividend income, and similar types of income, (ii) account balances, and (iii) sales proceeds from financial assets.

<sup>79</sup> For exchanges between E.U. Member States, the E.U. has implemented the C.R.S. through D.A.C.2., with a starting date that has been deferred by three months to December 31, 2020.

<sup>80</sup> The Ministerial Decree dated May 4, 2022 replaced Annex C (containing the list of reporting jurisdictions) and Annex D (containing the list of participating jurisdictions) of the Ministerial Decree dated December 28, 2015.

Although the deadline for transposition of Directive 2018/822/E.U. (“D.A.C. 6”) was December 31, 2019, D.A.C.6 was implemented in Italy by Legislative Decree n. 100 of July 30, 2020.

On November 17, 2020, a Ministerial Decree was published implementing rules for the automatic exchange of information on reportable cross-border arrangements. In addition, on November 26, 2020, Italian tax authorities published the practical requirements for D.A.C.6 reporting purposes.

According to D.A.C.6, an arrangement is deemed reportable if it contains at least one hallmark (*i.e.*, a list of the features and elements of transactions that present a strong indication of tax avoidance or abuse), and in respect of certain hallmarks, where the “Main Benefit Test” is met (that test will be satisfied if it can be established that the main benefit a person may reasonably expect to derive from an arrangement is the expected tax advantage).

Intermediaries, and in instances, taxpayers must provide notice of cross-border reportable arrangements to the Member State’s tax authorities. Cross-border arrangements must be reported within 30 days beginning on the day after whichever of the following list is earliest:

- The arrangement is made available for implementation.
- The arrangement is ready for implementation.
- The first step in its implementation has been taken.

Intermediaries and relevant taxpayers must file information on reportable cross-border arrangements,<sup>81</sup> the first step of which was implemented between May 25, 2018 and June 30, 2020 (“historical cross-border arrangements”). Initially, the reports were due by August 31, 2020. However, the adoption of Directive 2020/876/E.U., deferred D.A.C.6 reporting deadlines by up to six months. Italy opted to defer the reporting deadlines as follows:

- The date for the beginning of the 30-day period for reporting cross-border arrangements is to be deferred from July 1, 2020 to January 1, 2021.<sup>82</sup>
- The date for reporting historical cross-border arrangements that became reportable between June 25, 2018 to June 30, 2020 is to be deferred from August 31, 2020 to February 28, 2021.
- The date for the first exchange of information on reportable cross-border arrangements is to be deferred from October 31, 2020 to April 30, 2021.

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<sup>81</sup> See Legislative Decree n. 32 of March 1, 2023, implementing Directive 2021/514/UE (“D.A.C. 7”), which provides new reporting obligations for digital platform operators from December 31, 2023.

<sup>82</sup> As clarified by Italian tax authority in the Circular letter n. 2/E dated February 10, 2021, no penalties apply to late communications, provided that they are submitted by February 28, 2021. See also the Circular Letter n. 12/E, issued by the Italian Revenue Agency on May 13, 2022.

## ITALIAN MEASURES TO COMBAT B.E.P.S.

Fifteen specific actions have been or are being developed in the context of the O.E.C.D./G-20 project to combat base erosion and profit shifting (the “B.E.P.S. Project”). In substance, these actions cover all the principal aspects of international taxation – as they relate to C.F.C. rules, interest deductibility, artificial avoidance of permanent establishment status, transfer pricing rules, curbing harmful tax practices, data collection, mandatory disclosure rules, and dispute resolution.<sup>83</sup>

Italy is compliant regarding most of the B.E.P.S. actions:

- As recommended by Action Item 13, Italy has introduced Country-by-Country Reporting obligations into domestic law. See Article 1(145-146) of Law n. 208 of December 30, 2015.
- In order to incorporate the guidelines under Action 5, Italy has introduced several amendments to the Patent Box regime as described above in **New Patent Box Regime**. Provisions excluding trademarks from Patent Box eligibility were introduced to align the Italian Patent Box regime with O.E.C.D. Guidelines.
- In order to promote tax transparency and disclosure initiatives under Action Items 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 signed agreements regarding the exchange of information with Andorra, Barbados, the Cayman Islands, Chile, Cook Islands, Gibraltar, Guernsey, Hong Kong, the Isle of Man, Jersey, Liechtenstein, Luxembourg, Monaco, San Marino, Switzerland, Taiwan, and Vatican City.<sup>84</sup>
- Following the guidelines set out in B.E.P.S. Action 7, the domestic definition of the term “permanent establishment” was modified by Article 1 (1010) of Budget Law 2018. In particular, it contained amendments providing new rules for the prevention of artificial avoidance of permanent establishment status through specific activity exemptions, clarifying that activities that fall under the “negative list” must have a preparatory and auxiliary character in order to qualify.<sup>85</sup> New rules have also been introduced to prevent the artificial avoidance of permanent establishment status through *commissionaire* arrangements.<sup>86</sup> An anti-fragmentation rule<sup>87</sup> and a new definition of “closely-related person” were also introduced.<sup>88</sup>
- In respect to B.E.P.S. Action 1 addressing the tax challenges raised by digitalization, Italy unilaterally introduced a tax on digital services, as mentioned

“Italy is compliant regarding most of the B.E.P.S. actions.”

<sup>83</sup> For a list of all B.E.P.S. Actions, see Chapter 3 of this text, [“B.E.P.S. and Holding Companies.”](#)

<sup>84</sup> The abovementioned Ministerial Decree dated May 4, 2022 replacing the Annex C of the Ministerial Decree dated December 28, 2015 further extended the list of the reporting jurisdictions.

<sup>85</sup> Article 162 (4-4-bis) I.T.C.

<sup>86</sup> *Id.*, Article 162 (6-7).

<sup>87</sup> *Id.*, Article 162 (5).

<sup>88</sup> *Id.*, Article 162 (7-bis).

above at **Corporate Tax Rate**. This tax will be repealed upon the entry into force of internationally agreed measures on the taxation of the digital economy.

- In compliance with B.E.P.S. Action 12 related to mandatory disclosure rules, Italy has implemented D.A.C.6 on the automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements, as discussed above at **Automatic Exchange of Information**.
- Pursuant to Article 1 (1101) of Law n. 178 of December 30, 2020, Article 31-ter of Presidential Decree 600/1997 has been modified in compliance with B.E.P.S. Action 14, which states that countries with bilateral A.P.A. programs should provide for the rollback of A.P.A.'s. Based on the provision, an A.P.A. may apply retrospectively up to the tax year in which the request was submitted, provided that (i) the A.P.A. is based on agreement reached among Competent Authorities pursuant to the relevant income tax treaty, (ii) the facts and the circumstances underlying the A.P.A. were the same also in previous tax periods, and (iii) the taxpayer expressly requests that the A.P.A. will be applied retrospectively and submits amended tax returns.

Many of the new tax rules provided by the International Tax Decree and the A.T.A.D. Decree are closely linked to the B.E.P.S. Project reports released in 2014 and 2015,<sup>89</sup> including:

- 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 (see new Article 5 (1-*bis*) of Legislative Decree n. 29 of March 4, 2014, introduced by Article 1 (2) of Legislative Decree n. 32 of March 15, 2017).
- The (i) adoption of an effectively connected income concept for permanent establishments, repealing the so-called force of attraction rules that provided for the taxation of certain income produced in Italy but not effectively linked to the permanent establishment and (ii) introduction of the branch exemption regime, discussed above at **Branch Exemption Regime**.
- The reform of the interest deduction rules in order to discourage artificial debt arrangements designed to minimize taxes, as discussed above in **Interest Deduction** and the revision of the C.F.C. rules in order to deter profit shifting to low-tax or no-tax countries, as discussed above in **C.F.C. Legislation**. In consideration of the close connection between the C.F.C. regulation and the tax treatment of dividends and capital gains, the tax regime of profit distributions and capital gains and losses arising from sales of investments in

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<sup>89</sup> Other tax measures provided by the International Tax Decree, such as the new rules regarding domestic tax consolidation, which extend the option to apply the Italian consolidation regime to sister companies (including permanent establishments) that are controlled by the same foreign company resident in an E.U. Member State or E.E.A. Member State, allowing adequate exchange of information, are intended to comply with rulings of the E.C.J. “*SCA Group Holding and Others*,” Joined Cases C-39-41/13, delivered June 12, 2014, discussed above at **Domestic Consolidation**.



nonresident companies were modified as discussed above at **Dividend Exemption** and **Participation Exemption for Gains**.

- The modification of the regime for outbound and inbound transfers of company tax residence to prevent companies from avoiding tax when relocating assets, as provided in Article 166 and 166-*bis*, respectively, of I.T.C.
- The introduction of specific rules to neutralize the effects of hybrid mismatch arrangements aimed at preventing double deduction arrangements and deduction without income inclusion arrangements. Consequently, to the extent that a hybrid mismatch results in a double deduction no deduction is allowed in Italy. Where the Italian entity is the payer of the hybrid payment, the deduction is not allowed where the recipient of the hybrid payment and the maker of a related payment is resident in another jurisdiction and claims a deduction for the payment without taking the associated receipt into income.
- Other rules are introduced with reference to the case hybrid mismatches resulting from a deduction without inclusion, implementing Article 9 (2) of the A.T.A.D., which provides that to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer will deny the claimed deduction for the payment. Moreover, specific rules are provided with reference to the case of reverse hybrids and dual residence mismatches.<sup>90</sup>

The A.T.A.D. Decree did not modify the anti-avoidance rules and anti-abuse regime provided in Article 10-*bis* of Law n. 212 of July 27, 2000, as reviewed by the Legislative Decree n. 128 of August 5, 2015, known as the “Certainty Decree.” It was considered in compliance with the A.T.A.D.

## TAX REGIME FOR HOLDING COMPANIES CLASSIFIED AS S.I.C.A.F.’S

Definitions of undertakings for collective investment (“U.C.I.’s”) and alternative investment fund managers (“A.I.F.M.’s”) are provided by Legislative Decree n. 44/2014 (the “A.I.F.M. Decree”), which implements Directive 2011/61/E.U. (the “A.I.F.M. Directive.”) Some Italian holding companies could be deemed to be S.I.C.A.F.’s that are subject to the tax regime applicable to U.C.I.’s. Such treatment would be an exception to the general rule, that holding companies do not fall within the new definitions of U.C.I. and A.I.F.M.

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 in the following circumstances:

- It is a company that has shareholdings in one or more other companies.
- The commercial purpose of the shareholdings 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.

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<sup>90</sup> The abovementioned provisions related to hybrid mismatches have been effective from tax year 2020. The rules addressing reverse hybrid arrangements will enter into force starting from tax year 2022.

- The company is either (i) operating on its own account and whose shares are admitted to trading on a regulated market in the E.U. 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.<sup>91</sup>

Conversely, 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. A S.I.C.A.F. is defined to be (i) a closed-end U.C.I. in the form of a joint stock company having fixed capital, (ii) having a registered office and general management in Italy, and (iii) having as its exclusive purpose the collective investment of assets obtained by the offer of its own shares and other financial instruments of equity held by the same investors. 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 differs from 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 is exempt from the income tax. As a consequence, the group tax consolidation regime mentioned above is not permitted.

While the S.I.C.A.F. is exempt from income tax, the profits arising from investments carried out by the S.I.C.A.F. are taxed at the level of its investors through the application of a withholding tax. The withholding tax rate will depend on tax residence and subjective status of the investor. The dividend exemption and the participation exemption rules are not applicable to a S.I.C.A.F.

The voluntary transformation of a holding into a S.I.C.A.F. (authorized by the Bank of Italy) leads to immediate taxation of all unrealized gains on its assets because the transformation of a corporation into a “non-commercial” entity is a taxable event in Italy.<sup>92</sup>



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<sup>91</sup> See Article 4 of the A.I.F.M. Decree and A.I.F.M. Directive.

<sup>92</sup> Such position was confirmed by the Italian tax authorities in the recent Answer Ruling n. 370 of May 24, 2021.

# GERMANY

## Author

Dr. Wolf-Georg von  
Rechenberg  
BRL Böge Rohde  
Lübbehüsen  
Berlin, 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 E.U. At the same time, efforts have been made to prevent multinational businesses from using international financing structures which treat interest paid to shareholders as business expenses in Germany while leaving the profits of business operations taxable in tax havens. Germany has implemented all measures recommended under the E.U. Anti-Tax Avoidance Directive (the “A.T.A.D.”) and the recommendations of the O.E.C.D. regarding B.E.P.S. In some respects, Germany has introduced even stricter rules.

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 can range to 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 in addition to 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 same extent as other European economies, making 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.

The German economy continues to recover from several crises over the last few years (including the COVID-19 crisis, the Ukraine war, and the energy crisis), but these crises still affect the current situation. Ongoing inflation is having an impact on the German economy. To mitigate the economic consequences of these issues, several support packages and tax measures have been implemented by the German government.

## GENERAL TAXATION OF GERMAN CORPORATE ENTITIES

Generally, German companies are taxed depending on their structure under corporate law. A distinction is made between private companies (“*Personengesellschaften*”) and corporations (“*Kapitalgesellschaften*”). Since the beginning of 2022, private companies have the option to be taxed like a corporation.<sup>1</sup>

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<sup>1</sup> *Körperschaftsteuergesetz* (“KStG,” or the German Corporation Tax Act), §1a.

A German holding company (corporation) 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.<sup>2</sup> On top of the corporate tax, trade tax must 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%. In addition, 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 income taxable as defined by the Trade Tax Act.

## GENERAL PARTICIPATION AND 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, in the case of dividends, if the corporation holds at least 10% of the dividends-paying corporation. 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 avoid the use of hybrid financing structures, this beneficial treatment has 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.

In general, a German-resident corporation is obliged to remit withholding tax on dividends paid to foreign and domestic shareholders at a rate of 25%, plus a 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 basically a flat tax rate (irrespective of the individual tax rate), no further tax is due. In the case of business income, 60% 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.

### **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

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<sup>2</sup> The solidarity surcharge has been abolished for most individual taxpayers as of January 2021, but not for corporate entities.

includes profits from recaptures and hidden profit distributions upon the sale of shares below fair market value.

The participation exemption applies to a participation held directly or indirectly through a private company. This may be the case when Corporation A disposes of a share in a private company that owns an interest in Corporation B, or when a private company disposes a participation.<sup>3</sup> The participation exemption in private company structures also applies for trade tax purposes.

However, there are certain exceptions regarding this tax-free treatment, the most important of which are 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.<sup>4</sup>
- The exemption does not apply to shares held as current assets by a company engaged in financial business (“*Finanzunternehmen*”) that is more than 50% directly or indirectly owned by a financial institution.
- A general exception from the 95% participation exemption exists for banks and financial institutions, and also for life and health insurance companies.

Reductions in profits arising from corporate stock holdings (in particular, extraordinary write-downs) are disregarded in determining taxable income. This exception also applies to shareholder debt in the following circumstances:

- Reductions in profits in connection with a loan (e.g., write-downs to going-concern value, forgiveness of the unrecoverable portion of a debt claim)
- Reductions in profits in connection with securities and guarantees given for a loan
- 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 substantial shareholders and their related persons. The statute continues to apply even when the shareholder is no longer a substantial shareholder at the time of the reduction in profits.

The denial of a deduction does not apply where it is shown that an unrelated third party would have made the loan under the same circumstances or would not have required its repayment (arm’s length exception). Only security given by the company in question (the debtor) is taken into account for purposes of the arm’s length exception.

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<sup>3</sup> KStG, §8b, ¶16.

<sup>4</sup> *Id.*, §8b, ¶2, sent. 4.



## **Dividend Exemption**

The dividend exemption applies to dividends received from domestic and foreign participations.<sup>5</sup> For corporate tax purposes, there is no holding period. However, the dividend exemption applies only if the corporation receiving the dividend holds, at a minimum, a participation of 10% at the beginning of the fiscal year.<sup>6</sup> Below that threshold, the entire dividend payment is subject to tax at a normal rate of about 30%, including trade tax.

The dividend exemption also applies for trade tax purposes, if a participation of at least 15% has been held at the beginning of the calendar year. In the case of foreign dividends received, a participation of at least 15% must be held for an uninterrupted period since the beginning of the calendar year and the foreign company must 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 dividend received, as 5% of all dividends received are deemed to be nondeductible expenses. In principle, this applies regardless of the amount of effective business expenses related to the dividend. The hybrid mismatch rule applies as explained above under **Background**.

If the entity receiving the dividend has a participation of less than 10% in the paying entity, the dividends received do not qualify for the exemption and are not deemed to be 5% nondeductible.

## **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 discussed at **Earnings Stripping Rules**, below. This is an exception to the general rule of German tax law which provides that business expenses incurred in relation to tax-exempt income, such as dividends or capital gains, are not tax deductible.<sup>7</sup>

A different rule is applicable for trade tax purposes. When calculating trade tax income, 25% of the interest on debt exceeding €200,000 is added back to the tax base.

## **TRADE TAX ADD-BACKS AND DEDUCTIONS**

The income calculated for corporate tax purposes is adjusted for trade tax purposes by various add-backs and deductions.

The add-backs include 25% of the sum (exceeding €200,000) of the following items:

- Loan remuneration (e.g., interest)
- Recurring payments

<sup>5</sup> *Id.*, §8b, ¶1.

<sup>6</sup> *Id.*, §8b, ¶4.

<sup>7</sup> *Einkommensteuergesetz* (“EStG,” or the German Income Tax Act), §3c, ¶1.

*“The dividend exemption also applies for trade tax purposes, if a participation of at least 15% has been held at the beginning of the calendar year.”*

- Profit shares of a silent partner
- 20% of rental and leasing payments for moveable fixed assets
- 50% of rental and leasing payment for immovable 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 thereunder

The additional deductions that may be claimed include

- 1.2% of 140% of the assessed value (“*Einheitswert*”) of real property (and from 2025 on, 0.11% of the newly assessed property tax value (“*Grundsteuerwert*”));
- the distributive share of profits from an investment in a domestic or foreign partnership;
- dividends from a domestic corporation in which the Taxpayer holds an interest of at least 15% since the beginning of the tax year; and
- dividends from a foreign 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) from the beginning of the tax year, provided this corporation (almost exclusively) generates active income.<sup>8</sup>

## EARNINGS STRIPPING RULES

### General Concept

Several years ago, earnings stripping rules were introduced into the German income tax law, replacing the former thin capitalization rules.<sup>9</sup> The earnings stripping rules apply in general to all types of debt financing for sole entrepreneurs, 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 the taxpayer earns positive interest income in the corresponding financial year. Interest expense in excess of interest revenue (net interest expense) is deductible only up to 30% of tax E.B.I.T.D.A. (generally referred to as the “interest deduction ceiling”). For fiscal years beginning on or after January 1, 2024, several changes have come into force in accordance with the A.T.A.D. guidelines. The definition of “interest” was broadened, and the scope of allowable exceptions was modified.

Tax E.B.I.T.D.A. is defined as the taxable profit before the application of the interest deduction ceiling, increased by interest expenses and by fiscal depreciation and amortization, and reduced by interest earnings.

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<sup>8</sup> The active business requirement is not applicable to companies resident in an E.U. Member State.

<sup>9</sup> EStG, §4h; KStG, §8a.

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 expense in a tax period may be carried forward (known as “interest carryforward”). As is the case with the year in which interest carryforward arises, when carried to a subsequent year, the interest carryforward is not taken into account in determining the tax E.B.I.T.D.A. It simply may be claimed as a deduction to the extent the net interest expense in the subsequent year is less than the 30% of E.B.I.T.D.A. for that year. In a similar way, any tax E.B.I.T.D.A. amount that is not consumed by interest expense for the purpose of the earnings stripping rules in a particular year may also be carried forward (known as “E.B.I.T.D.A. carryforward”) to increase the ceiling in the carryforward year, with the limitation that if there is a positive interest balance in a financial year, no E.B.I.T.D.A. can be carried forward.

### **Exemptions**

A *de minimis* rule applies to the earnings stripping limitations on the deductibility of net interest expense. The earnings stripping rules apply only when interest expense exceeds positive interest income by at least €3 million (the “tax threshold”). Thus, small and medium sized business enterprises are generally exempt from the scope of the earnings stripping rules, provided the tax threshold for a year is not reached or exceeded.

The earnings stripping rules also do not apply to businesses that are not so-called related parties, as defined by Section 1 (2) of the German Foreign Tax Law.<sup>10</sup> Two companies qualify as related parties if (i) there is a direct or indirect shareholding in the share capital or the voting rights of more than 25% (significant shareholding), (ii) there is a claim to at least a quarter of the profit or liquidation proceeds, or (iii) a controlling influence can be exercised directly or indirectly. Two companies are also deemed to be related parties if a third party (a) has a significant shareholding in both companies (greater than 25%), (b) is entitled to at least one quarter of the profit or liquidation proceeds of both companies, or (c) can exercise a direct or indirect controlling influence over both companies. Furthermore, parties are deemed to be related if there is the possibility of exercising justified influence outside of business relationships, or if one party has a vested interest in the realization of the other party's income.

Furthermore, there is an escape clause for businesses that are part of a controlled group. Provided that the entity in question has an equity ratio – *viz.*, the percentage of balance sheet assets funded by equity – that is equal to or greater than 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. Consequently, the escape clause may be met when the equity ratio of the entity is 48% and the equity ratio of the controlled group is 50%. As indicated above, 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.

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<sup>10</sup> *Außensteuergesetz* (“AStG”).



The exemption for non-controlled corporations and the escape clause apply only if the corporation establishes that remuneration on shareholder debt accounts does not exceed 10% of the net interest expense of the relevant entity.<sup>11</sup> Shareholder debt is defined as debt that is granted by a substantial shareholder,<sup>12</sup> 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.

## RESTRICTING TAX DEDUCTIONS ON LICENSE PAYMENTS

There is a limit on the amount of a deduction that may be claimed for license payments.<sup>13</sup>

The section restricts the deduction of royalties and similar payments made to related parties if, in the other country, the payments are (i) subject to a preferential tax regime, such as an I.P. Box regime, and the rules in the other country are not compliant with the O.E.C.D. nexus approach presented in the B.E.P.S. Report on Action Item 5 and (ii) subject to an effective tax rate of less than 15%. A safe harbor exists for royalty payments to a company that carries on substantial research and development activities.

The percentage of the payment that will be nondeductible is calculated by making reference to the percentage shortfall between the effective rate and 15%. Stated mathematically, the formula is  $(15\% - \text{effective tax rate}) \div 15\%$ . For instance, if the effective foreign preferential tax rate is 10%, German law would regard 33.33% of all royalty payments as nondeductible. Because 10% amounts to 66.66% of 15%, the shortfall between the effective rate and 15% is 5% – which is 33.33% of 15%.

This also captures indirect license payments and will apply irrespective of any tax treaties (*i.e.*, treaty override).

## LOSS CARRYFORWARD

As a general rule, losses incurred in one fiscal year may be carried forward to following fiscal years, if they cannot be carried back.

Losses up to €1 million are carried back to the previous year, if possible. Furthermore, the deduction of any remaining losses is limited by the minimum taxation rules.<sup>14</sup> According to these rules, losses up to €1 million plus 70% of the losses exceeding €1 million may be deducted per year. The remaining exceeding losses may be carried forward. Loss carryforward is not limited in amount or in time.

If a company has losses carried forward in the amount of €2 million, it may use only €1.7 million in the carryforward even if it has a higher profit in that year (“minimum

<sup>11</sup> KStG, §8a, ¶2.

<sup>12</sup> Shareholder of more than 25%.

<sup>13</sup> EStG, §4j.

<sup>14</sup> *Id.*, §10b.

*“As a general rule, losses incurred in one fiscal year may be carried forward to following fiscal years, if they cannot be carried back.”*

taxation rule”). The nondeductible amount (30% in excess of €1 million) will again be carried forward.

The remaining losses are carried forward and can be used in future years within the limits described above of the minimum taxation rule.

A loss carryover may be reduced or eliminated if a change in ownership exists in the company incurring the loss. The rules in Germany’s KStG address the following situations:

- Losses are cancelled in full if more than 50% of the shares of a corporation are transferred within a period of five years. This rule has been questioned in court with regard to its possible violation of constitutional law. The lower Tax Court of Hamburg has submitted a case to the Constitutional Court and is awaiting a final decision.<sup>15</sup> No decision has been published yet.
- In the past, losses were cancelled in proportion to the percentage of shares transferred if more than 25% but less than 50% of the shares in a corporation were transferred within a period of five years. As a consequence of another decision of the Constitutional Court, this rule was abolished.<sup>16</sup>

A special rule was incorporated into §8c KStG in order to facilitate the preservation of losses during the takeover of a crisis-stricken company. An attempt by the European Commission (“the Commission”) to classify this as unlawful State Aid was rejected by the European Court of Justice (“E.C.J.”).<sup>17</sup> Therefore, §8d KStG, which relaxes the rules regarding cancellation of losses carried forward for share transfers within groups of companies or if the company’s business continues without major changes following the transfer, is applicable for share transfers of 50% or more.

Existing losses can be preserved following a share transfer aimed at avoiding a company’s bankruptcy if the essential operating structures of the business remain, which requires that one of the following prerequisites is met:<sup>18</sup>

- There is a works council agreement on the restructuring scheme that includes provisions for the preservation of a certain number of jobs.
- In the five years following the share transfer, the company pays at least 400% of the wages it has paid in the five years preceding the transfer.
- The company’s equity is raised by at least 25% of the company’s assets.

A company’s losses may also be preserved following a change in ownership where the losses cannot be used otherwise.<sup>19</sup> In cases where a new shareholder or a change in shareholders is necessary for the company to receive proper financing in order to avoid bankruptcy, the loss carryforward may be preserved if the company maintains the same business activities as prior to transfer. Business activities encompass the company’s services or products, its customers and suppliers, the

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<sup>15</sup> FG Hamburg, Beschluss v. 11.4.2018, 2 V 20/18, EFG 2018 S. 1128; FG Hamburg Beschluss v. 29.08.2017, 2 K 245/17, DStR 2017, 2377.

<sup>16</sup> Beschluss v. 29.3.2017, 2 BvL 6/11, BGBl I 2017 S. 1289.

<sup>17</sup> EuGH, Urteil v. 28.6.2018, C-203/16 P, C-208/16 P, C-219/16 P, C-209/16 P.

<sup>18</sup> KStG, §8c.

<sup>19</sup> *Id.*, §8d.

markets it serves, and the qualification of its employees. Further restrictions may also apply. The losses can be carried forward until they are fully used so long as no adverse event occurs, such as the closing of the business or the implementation of new business activities.

## REAL ESTATE TRANSFER TAX ON SHARE TRANSFER TRANSACTIONS

Under prior law, transfers of more than 95% of the shares of a corporation that owns real estate in Germany triggered the imposition of real estate transfer tax. The tax may be levied if the company or its subsidiaries own real estate. Moreover, the trigger looked at the aggregate of all transfers within a five-year window. The tax rate varies between 5% and 6.5% depending on the Federal state in which the real estate is located. The tax base is not calculated based on market value or book value, but through a special assessment procedure. A specific anti-avoidance rule exists.

For all acquisitions after June 2021, the trigger has been lowered from a 95% change to a 90% change in ownership, and the window was expanded from five years to 10 years. If the five-year-period ended prior to June 2021, the old rules will still apply.

## C.F.C. TAXATION

German tax law provides specific regulations for a shareholder of a controlled foreign corporation (“C.F.C.”) to curtail the perceived abuse of shifting income into low-tax jurisdictions.<sup>20</sup> Based on A.T.A.D. 2 and the Respective Transfer Act,<sup>21</sup> several adjustments have been implemented to comply with the directives. They are applicable for fiscal years beginning on or after January 1, 2022. The C.F.C. rules apply if all of the following conditions are met:

- More than 50% of the share capital or voting rights in the foreign intermedia company are held by a taxpayer who is subject to unlimited tax liability in Germany.
- The foreign corporation generates passive income.
- The foreign corporation is subject to low taxation (*i.e.*, its effective tax burden as determined according to German tax principles is below 15%, or for fiscal years that end before January 1, 2024, 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 target company sold by the C.F.C.

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<sup>20</sup> AStG, §7.

<sup>21</sup> Directive EU 2027/952 of 29.05.2017 and ATAD-Transfer Act (ATAD-UmsG) of 25.06.2021 = BGBl. 2021 I, 2035).

Special rules apply for companies generating investment type income. 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. Investment type income is income generated from liquid assets such as cash, securities, and participations. 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 abovementioned 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.<sup>22</sup> The income is now subject to the income of the shareholder for trade tax purposes.

Losses of the C.F.C. are not deductible by the German shareholder, but they may only be carried backward against profits of the C.F.C. to offset C.F.C. dividend income of the shareholder.

An exemption from the C.F.C. rules applies for a C.F.C. that maintains its registered office or place of management in a member country of the E.U. or E.E.A., provided the company carries on genuine economic activities in that country.<sup>23</sup> Genuine economic activities require a full-fledged business with an appropriate office, employees, and technical equipment. Generally, "genuine economic activities" are determined by the criteria stated by the E.C.J. in the *Cadbury Schweppes* decision. Only such income that is attributable to the genuine economic activity and that is derived by that particular activity is exempt from the C.F.C. rules, and only for amounts that do not exceed arm's length consideration.

Overall, the new rules are more detailed and require meticulous preparation, and in many cases, active reporting to the tax administration.

Within the package of new rules, the conditions for the German exit tax system have also been substantially changed.

## DIVIDEND WITHHOLDING TAX; TREATY NETWORK; ANTI-ABUSE PROVISIONS

### 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 the solidarity surcharge of 5.5%). Foreign corporations may claim a refund of two-fifths of the withholding tax (the effective withholding tax rate is 15% plus the solidarity surcharge). In many cases, lower rates will be levied under a double tax treaty. No dividend 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

<sup>22</sup> Foreign Relations Taxation Act, §10, ¶2, sent. 3 ("F.R.T.A.").

<sup>23</sup> *Id.*, §8, ¶2.



12 months.<sup>24</sup> This benefit is not applicable for private companies that are taxed like corporations.<sup>25</sup>

### **Treaty Network**

Germany has an extensive income tax treaty network with almost 100 income tax treaties in force and effect as of January 2024.

|                      |               |             |                   |
|----------------------|---------------|-------------|-------------------|
| Albania              | France        | Lithuania   | Slovenia          |
| Algeria              | Georgia       | Luxembourg  | South Africa      |
| Argentina            | Ghana         | Macedonia   | South Korea       |
| Armenia              | Greece        | Malaysia    | Spain             |
| Australia            | Hungary       | Malta       | Sri Lanka         |
| Austria              | Iceland       | Mauritius   | Sweden            |
| Azerbaijan           | India         | Mexico      | Switzerland       |
| Bangladesh           | Indonesia     | Moldova     | Syria             |
| Belarus              | Iran          | Mongolia    | Taiwan            |
| Belgium              | Ireland       | Montenegro  | Tajikistan        |
| Bolivia              | Israel        | Morocco     | Thailand          |
| Bosnia & Herzegovina | Italy         | Namibia     | Trinidad & Tobago |
| Bulgaria             | Ivory Coast   | Netherlands | Tunisia           |
| Canada               | Jamaica       | New Zealand | Turkey            |
| China                | Japan         | Norway      | Turkmenistan      |
| Costa Rica           | Jersey        | Pakistan    | Ukraine           |
| Croatia              | Kazakhstan    | Poland      | United Kingdom    |
| Cyprus               | Kenya         | Portugal    | United States     |
| Czech Republic       | Kosovo        | Philippines | Uruguay           |
| Denmark              | Kuwait        | Romania     | Uzbekistan        |
| Ecuador              | Kyrgyzstan    | Russia      | Venezuela         |
| Egypt                | Latvia        | Serbia      | Vietnam           |
| Estonia              | Liberia       | Singapore   | Zambia            |
| Finland              | Liechtenstein | Slovakia    | Zimbabwe          |

Germany has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Germany has nominated the treaties with France, Greece, Italy, Japan, Croatia, Luxembourg, Malta, Austria, Romania, Slovakia, Spain, the Czech Republic, Turkey, and Hungary for modification under the M.L.I., which came into force in April 2021.

### **Anti-Abuse Provisions**

Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies.<sup>26</sup> Under these restrictions, a foreign company is denied a reduced withholding tax rate to the extent it is owned by persons who

<sup>24</sup> EStG, §43b, ¶2.

<sup>25</sup> Schreiben v. 10.11.2021, IV C2 – S 2707/21/10001:004, BStBl. 2021 I, S. 2212.

<sup>26</sup> *Id.*, §50d, ¶3.

would not be entitled to a reduced rate according to the same legislation if they 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 received the dividends directly. The shareholders must be entitled according to the same legislation, *e.g.*, the same treaty.
- The gross income of the respective company in the respective fiscal year does not come from its own business activities.
- There are no economic or other substantial reasons for involving the company.
- The company has no business of its own and does not conduct general business activities.

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.

Legislation was enacted in 2021, addressing the following anti-abuse provisions for transactions involving companies based in a noncooperative jurisdiction:

- The disallowance of deduction for operating expenses and income-related expenses ultimately paid to a noncooperative jurisdiction
- Stricter taxation in cases of intermediate companies
- Tougher withholding tax measures in the case of profit distributions to a shareholder in a noncooperative jurisdiction
- Full taxation if shares of a subsidiary in a noncooperative jurisdiction is disposed of by a German resident

*“A different holding percentage may be applicable under the various treaties that are in effect.”*

## TRANSFER PRICING

### German Administrative Principles

German tax authorities are empowered to adjust reported income from transactions between related parties that are not carried out on an 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 that have been confirmed by the legislature 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, whereas 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 using a recognized transfer pricing method.

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 constructive dividend even if the transaction is carried out at arm's length.

The arm's length principle is also applicable for any transaction with a permanent establishment.

### **Transfer of Functions**

Provisions on the transfer of functions are included in the transfer pricing legislation. A function is transferred if it is relocated abroad with the associated opportunities and risks, including the assets and other benefits, also 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 has issued an extensive legal decree ("*Funktionsverlagerungsverordnung*") and administrative guidelines with practical examples.

### **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 (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 supported by a decree from the 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 the 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.

## **GERMAN INVESTMENT TAX LAW**

Until relatively recently, investment funds have been exempt from taxation and only individual investors were subject to tax, even if gains were not distributed. This favorable treatment of investment funds has changed in the following ways:

- Gains will be taxed at the level of the fund, not at the level of the investors.
- All funds are taxed according to the same scheme: on the basis of an annual lump sum.
- At the fund level, investment funds are partially subject to corporate tax on their domestic dividends, domestic rents, and profits from the sale of domestic real estate. The tax rate is 15% in each case, with an additional solidarity surcharge applicable to items other than domestic dividends.
- At the investor level, all distributions and profits from the sale of shares are in principle taxable. The aim is to tax national and foreign public investment funds equally.
- In order to avoid double taxation, certain distributions will be partially exempt from tax.

The Federal Ministry of Finance has issued several letters on the application of these rules.

## TRANSPARENCY REGISTER

Although it is not based on tax law but on anti-money laundering law,<sup>27</sup> the introduction of the German Transparency Register should be taken into account by a prospective direct investor in a German entity. From the year 2022, with different starting dates for different types of entities, all legal entities active in Germany have to file with this new register. The filing includes basic information about the type of entity, its entry in public registers, its share capital, and its place of business. The most important requirement is that the entity must report the entire chain of shareholders up to the ultimate beneficial shareholder. This also requires entities to provide information on indirect shareholdings or trust agreements. The failure to accurately report this information will be penalized. Although the register is not public, the tax authorities as well as other persons with legitimate interest will have access.




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<sup>27</sup> Money Laundering Act 23.06.2017, amended 23.06.2022. Federal Gazette I, p. 754.



# CYPRUS

## Author

Nairy Der Arakelian-Merheje  
Der Arakelian-Merheje LLC  
Nicosia, Cyprus

## GENERAL

In this current climate of socioeconomic and geopolitical turmoil, Cyprus has managed to maintain its position as an active and well-structured international business center catering to the requirements of international business entities and professionals. The key factors contributing to the status of Cyprus as an international base for holding companies remain the following:

- 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
- 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 Cypriot holding companies have recently been revised to adhere to E.U. directives based on the O.E.C.D.'s recommendations for combatting base erosion and profit shifting ("B.E.P.S. Project"). Tax structures are now carefully scrutinized with regard to the commercial reasoning behind various arrangements.

It should be noted that 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 (the "special defense contribution"). Each is discussed in turn.

## INCOME TAX

### **Tax Rate**

The statutory tax rate on annual net profit is 12.5%. An effective tax rate of as low as 2.5% could apply to companies claiming the notional interest deduction and to specific I.P. companies.

### **Basic Concept**

Both Cypriot resident companies and individuals are taxed on their worldwide income, which includes (i) business income, (ii) rental income, (iii) dividends, interest,

and royalties, (iv) goodwill, and (v) employment income, pensions, and directors' fees.

Nonresident companies generally are taxed only on (i) profits of a permanent establishment in Cyprus, (ii) rental income on immovable property in Cyprus, (iii) goodwill for a Cyprus business, and (iv) royalties

Nonresident individuals generally are taxed only on (i) employment income for services in Cyprus, (ii) pensions received in Cyprus, (iii) directors' fees, (iv) rental income on immovable property in Cyprus, (v) royalties, and (vi) professional fees.

New tax-resident, nondomiciled foreigners are not taxed on their passive income for 17 years.

## **Residence**

### **Corporations**

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 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. Accordingly, 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. All transactions are scrutinized very carefully, including the qualifications of the directors.
- The majority of the directors of the company are tax-resident in Cyprus and exercise their duties from Cyprus. Of extreme importance, directors must have suitable qualifications to carry out responsibilities.
- A physical administrative office is maintained in Cyprus, from which actual management and control of the business is exercised.
- Hard copies of commercial documentation (e.g., agreements and invoices) are stored in the company's office facilities in Cyprus.
- Accounting records of the company are prepared and kept in Cyprus.
- Bank accounts of the company are operated from Cyprus (bank signatory authority to be granted to directors resident in Cyprus), even if the accounts are maintained with banks established outside Cyprus.

### **New Additional Corporate Tax Residency Test**

In December 2021, an amendment to the Income Tax Law was published in the Cyprus Government Gazette (the "amended law") in which an additional corporate

*“An individual is considered to be resident in Cyprus for income tax purposes if physically present in Cyprus for a period exceeding 183 days in aggregate during a tax year.”*

tax residency test was introduced based on incorporation. This additional test aims to capture companies incorporated or registered in Cyprus that are not tax resident in any other jurisdiction.

In accordance with the amended law, the definition of resident in the Republic is expanded so that a company established or registered under any applicable law in the Republic is considered to be a resident of Cyprus even if its management and control are exercised from outside Cyprus, unless the company is tax resident in any other jurisdiction.

This means that companies incorporated or registered in Cyprus with management and control exercised outside of Cyprus will now be considered as Cyprus tax residents taxed in Cyprus on worldwide income if they are not tax resident in any other jurisdiction.

The amended law entered into force on December 31, 2022.

### Individuals and Executives of Corporations

An individual is considered to be resident in Cyprus for income tax purposes if physically present in Cyprus for a period exceeding 183 days in aggregate during a tax year.

An individual who is not physically present in any other state for a period exceeding 183 days in the aggregate during the same tax year and who is not a tax resident of any other state under the laws of that state may also be considered a tax resident of Cyprus for income tax purposes, when the following conditions are met:

- The individual is present in Cyprus for at least 60 days during the tax year.
- The individual pursues any business in Cyprus, works in Cyprus as an employee or independent consultant, or is a director of a company tax resident in Cyprus at any time during the tax year.
- The individual maintains a permanent residence in Cyprus that is either rented or owned.

This broadened definition of individual residence should have the effect of allowing an individual to be treated as a resident of Cyprus for income tax treaty purposes.

### Remuneration Exemptions

The following incentives apply for first-time employment in Cyprus:

- A 20% exemption on employment income for expatriates. The income tax legislation provides for a 20% exemption for the remuneration arising from first-time employment in Cyprus for an individual who meets each of two tests. The first is that, immediately prior to the commencement of first-time employment in Cyprus, the individual was not a resident of Cyprus for a period of at least three consecutive years. The second is that during the pre-arrival period, the individual was employed outside of Cyprus by a nonresident employer. The exemption is capped at €8,550 per year. It applies for a period of seven years commencing from the tax year following the year in which employment commences. Based on the current law, the exemption applies for individuals who commence employment after July 26, 2022 and before 2028.

- An exemption for expatriates earning over €55,000. The income tax legislation provides that individuals who were not Cyprus tax residents for at least fifteen consecutive years prior to the commencement of their first employment in Cyprus, and whose annual remuneration from their first employment in Cyprus exceeds €55,000, are entitled to an exemption from income tax with respect to 50% of such remuneration from employment. The exemption lasts for a period of 17 years. Based on the current law, the exemption applies to individuals who commence their first employment in Cyprus after 2021. It applies as well for individuals who commenced their first employment prior to 2022, subject to additional conditions.

### 90-Day Rule

Remuneration for salaried services rendered outside Cyprus for a non-Cypriot tax resident employer or to a foreign permanent establishment of a Cypriot-resident employer for more than 90 days in a tax year is exempt from income tax in Cyprus. Again, this provision should be helpful for individual residents of Cyprus who regularly work for an employer based outside of Cyprus in a low-tax jurisdiction. The Emirates come to mind as prime locations to work outside of Cyprus.

## **E.U. ANTI-TAX AVOIDANCE DIRECTIVE (A.T.A.D. 1 AND A.T.A.D. 2)**

On June 19, 2020, the Cypriot House of Representatives enacted amendments to the law to implement the first three provisions of the European Union (“E.U.”) Anti-Tax Avoidance Directive 1 (“A.T.A.D. 1”), *i.e.*, the limitation of interest rules, the C.F.C. rules, and the general anti-abuse rules, which came into effect on January 1, 2019. The remaining two provisions, the exit taxation rules and the Anti-Tax Avoidance Directive 2 (“A.T.A.D. 2”) hybrid mismatch rules, were introduced on July 3, 2020, and came into effect on January 1, 2020, except for the provisions on reverse hybrid mismatches which came into effect on January 1, 2022.

## **EXIT TAXATION RULES**

A company which is tax resident in Cyprus or a non-Cypriot tax resident company which has a permanent establishment (“P.E.”) in Cyprus, will be subject to tax on the excess of the market value of the transferred assets at the time of exit of the assets over the carrying value of the assets for tax purposes, in any of the following cases:

- A Cypriot tax resident company transfers asset(s) from its head office in Cyprus to its P.E. in another Member State or in a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.
- A non-Cypriot tax resident company with a P.E. in Cyprus transfers assets from its P.E. in Cyprus to its head office or another P.E. in another Member State or in a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.
- A Cypriot tax resident company transfers its tax residence from Cyprus to another Member State or to a third country, except for those assets which remain effectively connected with a P.E. in Cyprus.



- A non-Cypriot tax resident company with a P.E. in Cyprus transfers the business carried on by its P.E. from Cyprus to another Member State or to a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.

## HYBRID MISMATCH RULES

Broadly speaking, the purpose of the anti-hybrid mismatch rules of A.T.A.D. 2 is to ensure that deductions or credits are only taken in one jurisdiction and that there are no situations of deductions of a payment in one country without taxation of the corresponding income in another country. The rules are typically limited to mismatches as a result of hybridity and do not impact the allocation of taxing rights under a tax treaty.

## REVERSE HYBRID MISMATCHES

In relation to the rules regulating reverse hybrid mismatches, which came into effect on January 1, 2022, the amendment applies in situations where one or more associated non-Cypriot tax resident entities holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests, or rights to a share of profit in a hybrid entity that is incorporated or established in Cyprus are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person. The hybrid entity is regarded as a Cypriot tax resident and subject to tax under the income tax and the special defense contribution to the extent that that income is not otherwise taxed under the laws of Cyprus or any other jurisdiction.

## CAP ON INTEREST EXPENSE

On April 5, 2019, Cyprus passed legislation implementing the A.T.A.D. in the form of interest limitations to discourage artificial debt arrangements. Deductibility of interest has been limited so as not to exceed 30% of taxable income before taking into account the following items: (i) the excess of interest cost over interest income, (ii) taxes, (iii) depreciation of assets, and (iv) amortization of assets, together referred to as “E.B.I.T.D.A.” The limitation applies to interest expense under intragroup loans as well as third party loans.

There are some exemptions in the following instances:

- As an alternative to the cap based on E.B.I.T.D.A., up to \$3.0 million of interest may be deducted in all circumstances.
- This does not apply to companies that do not form part of a group and without related profit participation of at least 25%.

Companies in certain businesses are exempt from the ceiling on interest expense. Included in the exemption are credit institutions, investment firms, undertakings for collective investments in transferable securities (“U.C.I.T.S.”), insurance business, and pension institutions.

Subject to conditions, a corporate taxpayer may fully deduct excess interest if it can demonstrate that the ratio of its equity over its total assets is equal to or greater than the equivalent ratio of the group.

## CONTROLLED FOREIGN COMPANY (“C.F.C.”) RULES

In broad terms, the C.F.C. rules are intended to deter profit shifting to a low-tax/no-tax country. A C.F.C. is defined as an entity or a P.E. not taxable in Cyprus, where two conditions are met. The first is that a Cypriot tax resident company, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in such entity. The threshold is determined in terms of participation in the share capital, voting rights, or the entitlement to profits. The second is that a company or P.E. is low-taxed, *i.e.*, the income tax it pays is less than 50% of the Cypriot corporate income tax that it would have paid by applying the provisions of the Cypriot income tax law.

When a foreign company is a C.F.C., its profits that are not distributed within seven months from the close of the current year that result from arrangements that are not genuine are included in the income of the Cypriot shareholder. An exemption applies to a C.F.C. whose accounting profits do not exceed (i) €750,000 in total and whose passive income does not exceed €75,000 or (ii) 10% of its operating costs for the tax period.

An arrangement is regarded as nongenuine to the extent that the entity would not own the assets or would not have undertaken the risks which generate all or part of its income if it were not controlled by a company that carries out significant employee functions that are instrumental in generating the controlled company's income.

Computation of C.F.C. income is in accordance with Cyprus tax laws and in proportion to the taxpayer's profit share entitlement. Calculations ensure there is no double taxation. Any foreign tax paid is granted as a tax credit on the basis of the Income Tax Law sections 35 and 36.

## GENERAL ANTI-ABUSE (“G.A.A.R.”) RULE

These rules counteract aggressive tax planning. Cyprus will disregard an arrangement or a series of arrangements where the main purpose or one of its main purposes is to obtain a tax advantage contrary to the object or purpose of the tax laws. Where the tainted purpose exists, the arrangement is deemed not to be genuine. This means that, when taking into account all relevant facts and circumstances, it has not been put in place for valid commercial reasons reflecting economic reality. Where arrangements are ignored, the tax liability is calculated in accordance with the Cypriot income tax law.

## PERMANENT ESTABLISHMENTS

Profits from the activities of a permanent establishment outside of Cyprus are exempt. The definition of a P.E. under Cypriot tax law follows the definition found in Article 5 of the O.E.C.D. model convention.

## NOTIONAL INTEREST DEDUCTION (“N.I.D.”) ON EQUITY

### Former Provisions

In the past, interest paid by a Cypriot company was deductible only when such interest was actually incurred on a borrowing or other credit facility. The deductibility of the interest expense depended on whether the loan proceeds were used to finance taxable operations of the company or to acquire assets used in the business.

Interest paid in connection with intercompany loans was deductible, provided certain acceptable margins were maintained at the level of the Cypriot-resident company. In practice, the use of back-to-back loans creates beneficial ownership issues under double tax treaties. The issue is a hot button issue in the E.U. as a result of the Danish Cases discussed elsewhere in this compendium.

In the Danish Cases, the European Court of Justice (“E.C.J.”) held that European law contains an inherent concept that a lender receiving interest should not be considered to be the beneficial owner of the interest if an obligation exists to pay the proceeds of the interest to a third party pursuant to a separate borrowing. Consequently, back-to-back loans are being phased out and banks no longer remit funds in the second leg of a back-to-back arrangement except when all parties are related companies.

It should be noted that deductions for interest paid on borrowings to finance the acquisition of investments is allowed only in the case of wholly owned subsidiaries acquired after January 1, 2012.

### Provisions Currently in Effect

Today, the N.I.D. is allowed where investment is by way of equity instead of interest-bearing loans. Similar provisions have existed for years in Belgium and Italy.

The main provisions of the law are as follows:

- A deemed interest deduction will be allowed on “new equity” funds introduced into a resident company in order to carry on the business of the company.
- The deemed interest will be calculated on the basis of a reference interest rate. This rate is equal to the yield on the ten-year government bonds plus 5%.
- New equity means any equity funds introduced into the business after January 1, 2015, not including capitalization of reserves resulting from appreciation of movable and immovable property.

*“The definition of a P.E. under Cypriot tax law follows the definition found in Article 5 of the O.E.C.D. model convention.”*

- Equity includes both share capital and share premium to the extent actually paid up. The consideration for the issuance of the shares can be assets other than cash. In that case, the value of the loan cannot exceed the market value of the assets contributed. Other forms of equity contribution are not acceptable.
- The notional interest to be deducted cannot exceed 80% of the taxable income of the company, computed without taking into account the deduction of the notional interest. Consequently, in years with a tax loss, the N.I.D. cannot be claimed.
- Deductions for the N.I.D. are subject to the same rules as for actual interest paid. Hence, it is not deductible unless the proceeds relate to assets used in the business of the Cypriot company.
- Claiming the N.I.D. is at the discretion of the taxpayer on a yearly basis.

As the deemed interest is not paid, deducted but not paid N.I.D. should not be covered by provisions in the Multilateral Instrument (“M.L.I.”) and the E.U. Parent-Subsidiary Directive (“P.S.D.”) that deny the participation exemption for dividends that are deductible in the payor’s country of residence.

### **Anti-Avoidance Provisions**

Several anti-avoidance provisions are included in the legislation to protect against abuse of the new benefits, such as “dressing up” old capital into new capital, claiming the N.I.D. twice on the same funds through the use of multiple companies, or introducing arrangements that lack valid economic or commercial purposes.

### **Practical Uses**

Taking advantage of the N.I.D. would result in various benefits and eliminate potential issues:

- Higher share capital rather than large loans would be more beneficial from a business operational perspective.
- Under the participation exemption rules, it may benefit the parent company to receive dividends rather than interest, which would be taxable.
- For example, rather than lending its own funds to a subsidiary, a parent company (“Company A”) may make an equity contribution to its subsidiary (“Company B”). In the case of an equity contribution, Company A will not have taxable interest income, whereas Company B will get a deemed interest deduction. If, in a separate transaction, Company B distributes profits to Company A, the dividends received by Company A should be exempt from taxation in the hands of Company A, at least in principle.
- In cases where funds are used on back-to-back loans, beneficial ownership issues for interest received under an income tax treaty are subject to strict scrutiny. As previously mentioned, back-to-back loans were successfully challenged in the E.C.J. in the Danish Cases and are being phased out in Cyprus.



To illustrate, assume Company A, a resident of Country A, borrows funds from Company B, a resident of Country B. Company A lends the same funds to Company C, a resident of Country C. No treaty exists between Country A and Country C. In this case, the tax authorities of Country C may refuse tax treaty benefits when Company C makes payments to Company A because Company A is obligated to pay Company B all or most of the interest received. In these circumstances, Company A is not the ultimate beneficial owner of the interest because of its own obligation to pay the amount received to Company B.

Compare the foregoing result with a fact pattern in which Company A issues capital stock to Company B in return for a capital contribution. Company A then lends funds to Company C. Since Company A has no legal or contractual obligation to use the interest received from Company C to pay interest to Company B, no beneficial ownership issues should arise in Country C regarding payments to Company A. Of course, if Company A pays dividends to Company B within a relatively short time after receiving interest from Company C, the principle enunciated in the Danish Cases arguably could be applicable.

## EXPANSION OF THE DEFINITION OF THE REPUBLIC OF CYPRUS

The law has been amended so that the definition of the term “Republic of Cyprus” now includes, specifically and clearly, the territorial sea, the contiguous zone, the exclusive economic zone, and the continental shelf of Cyprus.

The law has also been amended so that the definition of a permanent establishment now includes all activities for the exploration and exploitation of the seabed in the exclusive economic zone and services related to such exploration or exploitation activities.

Gross income earned from sources within Cyprus (including those mentioned above) by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus that provides services listed above at **Basic Concept** would be subject to tax at the rate of 5%.

## TAX LOSSES GROUP RELIEF

Under the current provisions of the law, group loss relief can only be given for losses incurred by Cypriot resident companies. This means that losses incurred by a member of a group of companies can only be surrendered to another member of the same group, provided that both companies are tax residents of Cyprus.

In order to align the Cypriot tax law with the decision by the E.C.J. in the *Marks & Spencer* case, the law has been amended so that a subsidiary company that is tax resident in another E.U. Member State can surrender its taxable losses to another group member that is tax resident in Cyprus, provided the subsidiary has exhausted all the means of surrendering or carrying forward the losses in its Member State of residence or to any intermediate holding company.

When surrendering tax losses, taxable losses must be calculated on the basis of Cypriot tax law.

The law has also been amended to allow, for the purposes of determining whether two companies are members of the same group, the interposition of holding companies established in (i) another E.U. Member State, (ii) a state with which Cyprus has concluded a double tax treaty, or (iii) a state that has signed the O.E.C.D. multilateral convention for exchange of information.

## REORGANIZATION OF COMPANIES AND ANTI-AVOIDANCE PROVISIONS

The E.U. directive on mergers, acquisitions, and spinoffs has been implemented in Cyprus. Consequently, mergers, divisions, transfers of assets, and exchanges of shares can be affected 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 Cypriot 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 located outside Cyprus.

Several anti-avoidance provisions have also been introduced allowing the Tax Authorities the right to refuse to accept tax-free reorganizations if the Authorities are not satisfied that real commercial or financial reasons exist for the reorganization. In other words, the main purpose or one of the main purposes of the reorganization is the reduction, avoidance, or deferment of payment of taxes and that fact taints the tax-free nature of the transaction.

The Tax Authorities have the right to impose conditions on the number of shares which can be issued as part of the reorganization and the period for which such shares should be held (not more than three years).

However, such restrictions cannot apply in the case of publicly listed companies and transfers of shares as a result of succession.

## NEW TRANSFER PRICING REGULATIONS

Detailed transfer pricing documentation requirements exist in Cyprus, effective from January 1, 2022. The O.E.C.D. Transfer Pricing Guidelines have been adopted by Cyprus.

The transfer pricing rules apply to transactions between related parties, whether legal persons or individuals. For legal entities, parties are considered to be related when one entity owns shares in the other representing 25% or more of the total shares outstanding, 25% or more of the voting power of all shares entitled to vote, or 25% of the profits.

The Cypriot taxpayers that fall under the transfer pricing regulations must prepare and maintain transfer pricing documentation which consists of a local (Cyprus) file, a master file, and a summary table.



### **Local File**

A local file is required to be prepared by Cypriot taxpayers that enter into transactions with related parties when the following transaction thresholds are exceeded (per annum, per category), to indicate whether these transactions are in line with the arm's length principle:

- Financing transactions: €5,000,000
- All other categories of transactions (*i.e.*, goods, services, royalties and other intangibles, and others): €1,000,000

Cypriot taxpayers with related party transactions below the above thresholds are required to prepare simplified transfer pricing documentation. For certain types of transactions, safe harbor rules are provided.

### **Master File**

A master file is only required to be submitted by a Cypriot company that is the ultimate parent entity ("U.P.E.") or surrogate parent entity ("S.P.E.") of a multinational enterprise ("M.N.E.") groups with annual consolidated revenues exceeding €750 million in the preceding accounting year.

### **Summary Information Table**

The summary table should include a summary of the intercompany transactions by counterparties, and the transfer pricing documentation prepared in relation to such transactions.

## **D.A.C.6 IMPLEMENTATION IN CYPRUS**

As a member of the E.U., Cyprus is subject to the same obligation as all other E.U. states to implement the Directives on Administrative Cooperation ("D.A.C.") including D.A.C.6, and the Cypriot law implementing D.A.C.6 was passed March 18, 2021.

### **General Considerations**

The Ministry of Finance ("M.O.F.") is aware that the scope of D.A.C.6 reporting obligations is broad and that it may capture arrangements that arise for commercial reasons more than for tax planning reasons. Consequently, the M.O.F.'s view on the Main Benefit Test ("M.B.T.") is to compare the value of (i) tax advantages against (ii) other benefits and considerations on a case-by-case basis.

The Cypriot Tax Department defines tax benefit as any of the following advantages:

- The grant of relief or an increase in previously granted relief on tax
- Avoiding tax or reduction of tax
- Deferral of tax payments
- Avoidance of an obligation to withhold tax

The cardinal element of the proposed law is that the tax advantage reported under D.A.C.6 must be seated in the E.U. This means that an arrangement resulting in a

*“The internal taxes that will be addressed by the Cypriot legislation include only the Income Tax, the Special Defense Tax, and the Capital Gains Tax.”*

tax benefit which affects only the tax base of a non-E.U. jurisdiction does not fall within the M.B.T.

Ultimate beneficial owners of Cypriot companies are monitored in existing compliance rules. If any individual who is a tax resident of a Member State of the E.U. secures tax treatment in Cyprus that adversely affects the tax base of that E.U. Member State, information on that cross-border arrangement (“C.B.A.”) will be captured by the law and will be reportable.

The objectives of the M.O.F. are identical to those of the E.U. Consequently, the reporting obligation in Cyprus will include targeting and capturing potentially aggressive tax planning arrangements resulting in tax base erosion of one or more E.U. Member States.

### **Continued Application of Other Directives**

In addition to D.A.C.6, the Cypriot government will continue to adhere to all previous directives on administrative cooperation in the field of taxation. These include (i) targeting attempts at circumventing mandatory automatic exchanges of financial information (such as C.R.S.), (ii) exchanges of information on cross border tax rulings, (iii) country-by-country reporting, and (iv) facilitating access to anti-money laundering information by tax authorities.

Regarding reportable arrangements to be included in D.A.C.6, the M.O.F. has adopted the minimum standards under which D.A.C.6 reporting will not be required for local arrangements and for arrangements with non-E.U. states where the tax base of an E.U. Member State is not affected adversely.

The internal taxes that will be addressed by the Cypriot legislation include only the Income Tax, the Special Defense Tax, and the Capital Gains Tax. No other direct or indirect taxes are covered by the proposed law. Penalties for noncompliance with various reporting obligations may not exceed €20,000 per reportable C.B.A.

### **Basics Adopted by Cyprus**

The basic provisions addressed by the legislation and enacted are listed below.

#### **The M.B.T. and the Hallmarks Falling Within the M.B.T**

This includes hallmarks falling into Categories A and B, as well as certain categories falling into Category C. These are the following:

- **A. Generic Hallmarks**
  - A1. Confidentiality
  - A2. Contingent/Success Fees
  - A3. Standardized Documentation
- **B. Specific Hallmarks**
  - B1. Use of Losses
  - B2. Conversion Income into Capital
  - B3. Circular Flows/ Round-Tripping

- **C. Cross Border Transactions**

- C1. Deductible Payments, Low or No Tax, Tax Exempt and Preferential Regimes

*The Hallmarks Not Requiring a Finding as to the M.B.T.*

These Reportable C.B.A.'s are defined widely. Among other elements, Reportable C.B.A.'s will include the following:

- **C. Cross Border Transactions, continued**

- C1. Transactions between Cypriot companies and companies and other entities based in E.U. and O.E.C.D. blacklisted countries, and transactions between Cypriot companies and recipients of income who are not tax resident in any country
- C2. Transactions otherwise resulting in deduction of depreciation on the same asset in multiple jurisdictions
- C3. Transactions resulting in double taxation relief claimed twice
- C4. Transfers of assets significantly projected to reduce valuation of the transferor's income stream

- **D. Automatic Exchanges of Information ("A.E.O.I.")**

- D1. Arrangements which circumvent A.E.O.I. by utilizing jurisdictions that are not regulated or compliant must be reported

- **E. Transfer Pricing**

- E1. Transfer pricing elements such as exploiting the existence of safe harbor rules
- E2. Transfer of hard-to-value intangibles in an arrangement
- E3. Intragroup cross border transactions (less than 50% E.B.I.T. test)

**Definition of Intermediaries**

In general, the Cypriot Government has adopted the definition of an intermediary that is provided by D.A.C.6. Consequently, intermediaries include all persons devising, drafting, advising on, and marketing tax planning arrangements. Also included are persons that assist in implementing those arrangements.

Exemption has been granted to those providing tax compliance and auditing services. Lawyers have also been exempted due to professional confidentiality regulations in Cyprus, but the same conditions apply as with other E.U. Member States.

**Further Cyprus Considerations**

Cyprus adopted the position that E.U. approved tax schemes do not fall within the proposed D.A.C.6 law. This covers the I.P. Box regime, the Tonnage Tax regime in the shipping industry, and the N.I.D.

Regarding Hallmarks that are applicable without reference to the M.B.T., the Cypriot position is that most of these will only be applicable provided the arrangements in question are with legal entities based in countries on the E.U. or O.E.C.D. Noncooperative Jurisdiction lists. Cyprus strictly implements rules attacking transactions with companies based in such listed jurisdictions.

Cyprus has adopted the common goal of E.U. tax authorities to react proactively and decisively when tax rules may facilitate aggressive and harmful tax practices.

The M.O.F. has adopted a policy that ensures access to a level playing field for large and small taxpayers.

## **U.B.O. REGISTERS**

The Anti-Money Laundering Law (“A.M.L.”) amending the Cyprus A.M.L. legislation with the implementation of the E.U. Directive 2018/843 specifically on the Ultimate Beneficial Owners (“U.B.O.”) registers was enacted on February 23, 2021 and therefore Cyprus maintains U.B.O. registers.

### **Multiple Registers**

The created registers are as follows:

- Register of the Crypto Assets Service Providers – kept by Cyprus Securities and Exchange Commission
- Register of the Electronic Registry of Bank accounts, Payment Accounts and safe Boxes – kept by the Central Bank of Cyprus
- Beneficial Ownership Register of Companies and other legal entities – kept by the Department of the Registrar of Companies and Official Receiver
- Beneficial Ownership Register of Express Trusts and Similar arrangements – kept by Cyprus Securities and Exchange Commission
- Beneficial Ownership Register of legal bodies (foundations, clubs, unions etc.) – kept by the General Commissioner

The one that concerns businesses is the Beneficial Ownership Register of Companies and other legal entities which is to be maintained by the Registrar of Companies.

### **Definition of Beneficial Owner**

According to Guidance issued by the Registrar of Companies, the beneficial owner” means any natural person or persons who ultimately own or control the company and the natural person or persons on whose behalf a transaction or activity is being conducted.

In practice U.B.O.’s are all those persons who own 25%+1 share of the issued share capital of a company. If such a U.B.O. cannot be determined, then the decisive factor is determining the physical person or persons who exercise effective control over the company.

The above is the very basic definition on reportable U.B.O.s but further criteria exist on a case-by-case basis.

## **Information to be Filed at the Registrar of Companies**

### **Legal Entities**

- Name, surname, month and year of birth, nationality, and residential address
- Nature and extent of the beneficial interest held directly or indirectly by each beneficial owner, including percentage of shares, voting rights
- Identification document number indicating the type of document and the country of document issuance (Identity card or passport depending on the specific facts)
- Date on which the natural person was entered in the register as beneficial owner
- Date of changes in the particulars of the natural person or the date on which the natural person ceased to be a beneficial owner

### **Trusts**

- Name
- Registration number, if any
- Jurisdiction
- Nature and percentage of beneficial interest
- Date when it became a U.B.O.
- Date of any changes and/or cancellation of shareholding

### **Internal Register**

All professionals/service providers must also maintain internal registers separately with all of the data as mentioned above in the same format as filed at the Registrar of Companies in addition to the usual legally required Due Diligence/Know Your Client files of each client.

The above obligation is two pronged as it covers both the service providers as well as the Directors/Secretary of each company.

### **Penalties**

Penalties include €200 fixed fees plus €100 per additional day of noncompliance, with a cap of €20,000 per company.

### **Access to Information**

The following persons and officials have access to the information in the registers:



- Competent governmental supervisory authorities have access without notifying the entity.
- Responsible entities within the process of conducting statutory due diligence will have restricted access to the following:
  - Name
  - Month and year of birth
  - Nationality
  - Country of residence
  - Nature and extent of interest
- The general public has restricted access to the same information as obliged entities.

## SPECIFIC INCOME TAX BENEFITS

Certain types of income that may be subject to favorable tax treatments are discussed in the following sections.

### **Shipping**

Under the reciprocal exemption provisions, in the case of a shipping business, profits or benefits arising from the business of operating and managing ships benefit from exemption from income tax 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 Merchant Shipping Law of 2020 provides for an increase in the tonnage tax applicable to qualifying ship owning and ship management companies. The resulting tax is substantially lower than the annual corporate income tax of 12.5%. The amended law is in line with the E.U. Commission's approval of the tonnage tax which is in line with E.U. Guidelines on State Aid to the maritime transport industry.

The key changes to the law are as follows:

- The Merchant Shipping Law has been extended until December 2029.
- The definition of the term "maritime transport" has been amended to include ancillary activities to maritime transport provided certain qualifying conditions are met.
- The term "Qualifying Ship" has been further defined with the addition of lists of both qualifying and excluded vessels.
- Bareboat charters within the same group, meaning intragroup transactions, are now eligible under tonnage tax.



- The new law provides for a further reduction in tonnage tax by 30% for E.U./E.E.A. vessels which use methods for environmental preservation of the marine environment and reduction of effects on climate change.
- The Law further extends tax benefits to sea fare of E.U. and E.E.A. registered ships.

### **Intellectual Property**

Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the effective rate of 10% of the amounts paid, subject to treaty provisions. Withholding tax is imposed on film rental income derived by a nonresident with Cyprus source income at the rate of 5% subject to treaty provisions. However, the E.U. Royalties Directive applies in the case of film rentals.

Royalties paid for the use of I.P. rights outside Cyprus are not subject to withholding tax.

Additionally, an I.P. Box regime allows for an exemption from taxation of 80% of the gross income from use of intangible assets. The key provisions of the regime are discussed below.

#### **Qualifying Intangible Assets**

A qualifying intangible asset is an asset that was acquired, developed, or exploited by a person in furtherance of its business (excluding intellectual property associated with marketing). The I.P. must be the result of research and development activities. A qualifying intangible asset includes intangible assets for which only economic ownership exists, such as (i) patents, (ii) computer software, and (iii) certain specified assets.

#### **Qualifying Profits**

Qualifying income means the proportion of the overall income corresponding to the fraction of the qualifying expenditure plus the uplift expenditure, over the total expenditure incurred for the qualifying intangible asset. Income includes (i) royalties for the use of the asset, (ii) amounts received from insurance or as compensation, (iii) gains from the sale of the intangible asset, and (iv) embedded intangible income that is reflected in the sale of inventor or other assets.

#### **Qualifying Expenditures**

A qualifying expenditure is the sum of total research and development costs incurred in any tax year, wholly and exclusively for the development, improvement, or creation of qualifying intangible assets, the costs of which are directly related to the qualifying intangible assets.

## **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.

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.

*“Royalties paid for the use of I.P. rights outside Cyprus are not subject to withholding tax.”*

Interest income derived from investments attracts the Special Defense Levy, which is discussed below at **Special Contribution for the Defense of the Republic**. According to the I.T.L., profit from the sale of so-called titles is tax exempt. In Tax Circular No. 2008/13 dated December 17, 2008, amended by Circular No. 2009/6 dated May 29, 2009, the Cypriot Tax Authorities gave a list of investment products that constitute titles, the most important of which include (i) ordinary shares, (ii) founder's shares, (iii) preference shares, (iv) options on titles, (v) debentures, (vi) bonds, and (vii) short positions on titles.

Dividends paid into a Cypriot holding company are exempt from income tax, provided that hybrid rules do not apply (see **Anti-Avoidance Provisions for Hybrid Instruments and Artificial Transactions for Dividends**).

Furthermore, no withholding tax is payable when dividends are paid by a Cypriot holding company to its nonresident shareholders. However, under a recent amendment of the Special Defense Contribution law, when a nonresident company is situated in a jurisdiction included in the list of jurisdictions that have been assessed by E.U. Member States collectively as noncooperative for tax purposes, or if it is incorporated or registered in such a jurisdiction and is not tax resident in another Member State not included in that list, and it receives any dividends from a company resident in Cyprus, a 17% withholding tax must be withheld from the amount of the dividend.

The combination of an exemption for share gains and an absence of tax on dividend income received or paid by a Cypriot holding company likely accounts for the number of nonresident-owned holding companies in Cyprus since its accession to the E.U.

Nonetheless, changes to the P.S.D. will affect the use of Cyprus as a holding company jurisdiction. The choice of Cyprus as the location for a group holding company must reflect valid commercial decisions and must not have been adopted for improper tax planning purposes. Where these facts are not demonstrated, other E.U. Member States can treat Cypriot holding companies as look-through entities when the substance and activities tests are not satisfied.

Additionally, a unilateral tax credit is allowed in Cyprus for taxes withheld or paid in other countries where no bilateral agreement or double tax treaty is in force.

## LOAN INTEREST

The 9% notional interest on loans or other financial facilities has been eliminated, but if individuals resident in Cyprus are the recipients, such loans are considered 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. Back-to-back loans do not generate notional interest and are now being phased out.

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 actual days spent 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.

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.

## **ANTI-AVOIDANCE PROVISIONS FOR HYBRID INSTRUMENTS AND ARTIFICIAL TRANSACTIONS FOR DIVIDENDS**

Under current law, dividends are exempt from income tax but are subject to defense tax for tax-resident Cypriot individuals and, in a number of cases, for companies.

In some cases, a payment received by a Cypriot company from a company located outside of Cyprus may be considered a dividend in Cyprus, while also being treated as a tax-deductible expense in the country of the company making the payment. These are known as “hybrid instruments.”

An example of a hybrid instrument may arise where dividends are paid on preferred shares. In Cyprus, these payments are considered dividend income, whereas in the payer’s country of residence, these payments may be considered interest paid, and therefore, they may be allowed as a tax-deductible expense.

The P.S.D. excludes these payments from benefits in order to prevent the double nontaxation of these dividends. Cypriot tax law has been amended so that dividends that fall under the above provisions are not exempt from income tax when received by a Cypriot resident company. Instead, these dividends will be taxed as normal business income subject to income tax but exempt from defense tax.

In addition, the P.S.D. does not apply in cases where there is an arrangement, or series of arrangements, between the dividend-paying company and the dividend-receiving company that have been put into place where the main purpose or one of the main purposes relates to a tax advantage that defeats the object or purpose of the P.S.D. This type of arrangement is not regarded as genuine unless put in place for valid commercial reasons which reflect economic reality.

The tax law in Cyprus follows these rules.

## **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.



### **Scope of Levy**

The Special Defense Levy on interest income from investments is imposed at the rate of 30%. The Levy only applies to residents of Cyprus. Nonresident and tax resident but non-domiciled shareholders of Cypriot resident companies are not subject to the Special Defense Levy.

Both individuals and the eligible companies can benefit from a 3% Levy for interest income received or credited from government savings certificates and development bonds and interest from corporate bonds of listed entities, provided that the interest does not accrue from the ordinary conduct of their business activity.

Interest received in the ordinary course of business is exempt from the Levy.

Dividends paid from one Cypriot resident company to another are exempt from the Levy. Dividends received by a resident company from a nonresident company 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. 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 the Special Contribution for the Defense of the Republic.

## **OTHER TAXES**

### **Capital Gains Tax**

#### **In General**

Capital gains tax is charged on the disposal of immovable property located in Cyprus or on the disposal of shares of companies that directly own immovable property located in Cyprus. Gains from the sale of shares in a company that indirectly owns immovable property in Cyprus, by directly or indirectly holding of shares in a company that owns such property, will also be subject to capital gains tax. However, this tax will apply only if the value of the immovable property represents more than 50% of the value of the assets of the company whose shares are sold.

The scope of the tax can be illustrated as follows:

- Company A owns shares of Company B, which owns the shares of Company C, which in turn owns immovable property located in Cyprus.
- Capital gains tax will arise if Company C sells the immovable property or Company B sells the shares of Company C.
- Capital gains tax will arise if Company A sells the shares Company B in the above fact pattern.

In the case of the sale of shares of a company owning immovable property, the gain to be taxed will be calculated only based on the market value of the immovable property, which is held directly or indirectly.

### Trading Gains from the Sale of Shares of Property Companies

Currently, if an entity is engaged in the sale of shares of companies such that the transactions are considered to be of a trading nature, any gains from the sale of such shares are exempt from income tax pursuant to the provisions of Cypriot income tax laws. Since these gains are not within the scope of capital gains tax law, the gains are tax-free, even if the shares being sold relate to a company that owns immovable property located in Cyprus.

Under the new legislation, these gains would remain exempt from income tax but would now be subject to capital gains tax.

### **Transactions Between Related Parties**

In the case of the sale of property between related persons, the Tax Authorities have the right to replace the sale price declared by the parties concerned with the market value of the property sold, if, in his opinion, the selling price declared is lower than the market value.

### **Inheritance and Estate Taxes**

There are no such taxes imposed on bequests or inheritances of shares held in a Cypriot company.

### **Thin Capitalization Rules**

Cypriot 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 specific rules to address business structures 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 the businesses differ substantially from those that would exist between independent businesses.

Under these circumstances, any profits that would have accrued to one of the businesses in the 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 Cypriot resident company or other person for income tax purposes where it is of the opinion that the Cyprus profits have been understated because of the special relationship between the Cypriot resident person and the other party to a transaction.

## **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 noncompliance penalties.

Now, a company is required 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 one of the “Early Adopters” of the Common Reporting Standard (“C.R.S.”). Cyprus imposes an obligation upon Cypriot financial institutions to affect an automatic exchange of information through the Central Bank of Cyprus with all other jurisdictions that are signatories of the C.R.S. convention. Bank forms require the provision of the tax identification numbers in the home country of ultimate beneficial owners (“U.B.O.’s”).

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 Tax Authorities receive an inquiry from the tax authority of another signatory state, Cyprus is obliged to provide information without resorting to the procedure described below, so long as certain conditions of the local legislation are satisfied. Fishing expeditions will not be permitted.

For inquiries not related to the C.R.S., the Director of Inland Revenue (the “Director”) retains the right to request that a bank provide information it possesses in relation to any existing or closed bank account of a person under investigation within a period of seven years preceding the date of the request. Prior to making such a request, the Director must obtain written consent from the Attorney General (“A.G.”) and furnish a relevant written notice to the person under investigation with.

The Director must inform the A.G. of the tax purpose and the reasons for which the information is requested. In order to obtain consent from the A.G., the Director should apply directly to the A.G. and furnish both the A.G. and the bank with all of the following information:

- 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 (specific and reasoned) period of time for which the information is requested
- 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 person under investigation of the written consent, or the refusal of such consent, by the A.G. as soon as this information is made available.

*“Cyprus is a signatory of the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters.”*

## 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 private Cypriot companies within their structures. Such disclosures include the length of time shares are held, copies of transaction documents, confirmation from the board of directors that the Cypriot company is managed and controlled in Cyprus, proof of the appropriate qualifications and experience of the directors, and evidence of an actual physical presence in Cyprus.

With planning, proper record keeping, and the adoption of rules regarding economic substance, corporate residents of Cyprus have successfully claimed treaty benefits from foreign tax authorities.

## DOUBLE TAX TREATIES

### In General

Cyprus has developed an extensive network of double tax treaties that offer excellent opportunities for international tax planning for a wide range of businesses. Set out below is the table of jurisdictions.

|                      |          |            |              |
|----------------------|----------|------------|--------------|
| Andorra              | Ethiopia | Latvia     | Serbia       |
| Armenia              | Finland  | Lebanon    | Seychelles   |
| Austria              | France   | Lithuania  | Singapore    |
| Bahrain              | Georgia  | Luxembourg | Slovakia     |
| Barbados             | Germany  | Macedonia  | Slovenia     |
| Belarus              | Greece   | Malta      | South Africa |
| Belgium              | Guernsey | Mauritius  | Spain        |
| Bosnia & Herzegovina | Hungary  | Moldova    | Sweden       |
| Bulgaria             | Iceland  | Montenegro | Switzerland  |
| Canada               | India    | Norway     | Syria        |
| China                | Iran     | Poland     | Tajikistan   |

|                     |            |              |                      |
|---------------------|------------|--------------|----------------------|
| C.I.S. <sup>1</sup> | Ireland    | Portugal     | Thailand             |
| Croatia             | Italy      | Qatar        | Turkmenistan         |
| Czech Republic      | Jersey     | Romania      | Ukraine              |
| Denmark             | Kazakhstan | Russia       | United Arab Emirates |
| Egypt               | Kuwait     | San Marino   | United Kingdom       |
| Estonia             | Kyrgyzstan | Saudi Arabia | United States        |

### **Cyprus-U.K. Income Tax Treaty**

The double tax treaty between Cyprus and the U.K. provides for zero withholding taxes on dividends, as long as the recipient is the beneficial owner of the income. The same will also apply to withholding taxes on interest and royalty payments. Gains from the sale of real estate owned by a company will be taxed in the country where the property is located (except for shares of companies traded on a stock exchange).

In determining the tax residency of a company that qualifies as a tax resident in both countries under their respective domestic tax laws, the competent authorities will take into account (i) the place where the senior management of the company is carried out, (ii) the place where the meetings of the board of directors or equivalent body are held, (iii) the place where the company's headquarters are located, (iv) the extent and nature of the company's economic nexus in each country, and (v) whether determining that the company is a resident of one country but not of the other for the purposes of the tax treaty would carry the risk of an improper use of the treaty or inappropriate application of the domestic law of either country.

As expected, a limitation of benefits clause has been inserted into the new tax treaty based on the P.P.T. The clause provides that no benefit will be granted under the treaty with respect to an item of income or a capital gain if it is reasonable to conclude, having considered all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in such benefit.

## **THE B.E.P.S. PROJECT – IMPLICATIONS FOR CYPRUS**

As previously noted, the main tax provisions relating to Cypriot holding companies have recently been revised in light of E.U. directives and O.E.C.D. recommendations under the B.E.P.S. Project. The B.E.P.S. Project contains 15 specific actions. The impact of these actions on Cypriot tax law is detailed below.

### **B.E.P.S. Action 2 (Hybrid Mismatches)**

The effects of B.E.P.S. Action 2 have been discussed above, in **Hybrid Mismatch Rules**.

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<sup>1</sup> The treaty concluded between Cyprus and the former U.S.S.R. is applicable to Azerbaijan, Uzbekistan, and Republics of the Commonwealth of Independent States ("C.I.S.") until such time they wish to abrogate the treaty.



*“With the introduction of the 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 at the end of the year 2021.”*

### **B.E.P.S. Action 3 (Effective C.F.C. Rules)**

C.F.C. rules have now been introduced. The rules are discussed above in **Controlled Foreign Company (“C.F.C.”) Rules**.

### **B.E.P.S. Action 4 (Interest Deductions)**

B.E.P.S. Action 4 will likely affect Cypriot companies receiving interest income when the jurisdiction of residence of the debtor company introduces measures disallowing deductions for interest expense. In addition, Cyprus has adopted a ceiling on interest expense deductions based on E.B.I.T.D.A. This is discussed in **Cap on Interest Expense**, above. It has also enacted an N.I.D. provision that de-emphasizes overly aggressive debt structures. See the discussion in **Notional Interest Deduction (“N.I.D.”) on Equity**, above.

### **B.E.P.S. Actions 5 (Transparency and Substance)**

As previously discussed in **Intellectual Property**, the I.P. Box regime in Cyprus has become fully compliant with O.E.C.D. Guidelines with the adoption of the “nexus approach.” Intangible assets must be developed in Cyprus in order to claim tax benefits. Benefits afforded under the prior regime were phased out in 2021.

With the introduction of the 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 at the end of the year 2021.

### **B.E.P.S. Action 6 (Inappropriate Treaty Benefits)**

Cyprus has signed the M.L.I., and regarding access to treaty benefits has chosen the P.P.T. for the limitation of benefits (“L.O.B.”) provision.

An L.O.B. provision will now 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 or substance in Cyprus.

Cyprus intends to amend its existing double tax treaties to include an L.O.B. provision. For example, the new Cyprus-U.K. tax treaty provides for a limitation of benefits as discussed in **Double Tax Treaties**.

So far, structures under which income is reduced by the 80% notional interest deduction have withstood scrutiny. However, several E.U. Member States have eliminated the provision.

Action Item 6 is likely to result in a considerable number of new treaty provisions. It is likely that Article 3 of a new model treaty will include a definition of “special tax regime” that provides a preferential tax rate for specific items of income, including a notional interest deduction. New provisions will likely be included in Articles 11, 12, and 21 of the O.E.C.D. Model Income Tax Treaty to deny lower treaty withholding tax rates on interest, royalties, or other income when a recipient benefits from low-tax regimes.

### **B.E.P.S. Action 10 (Arm’s Length Transfer Pricing – Profit Split Method)**

Cypriot companies are often used to provide administrative services to intragroup companies. Following the implementation of B.E.P.S. Action 10, the Cypriot company

must 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 of the payer.

### **B.E.P.S. Action 13 (Transfer Pricing Documentation)**

On December 30, 2016, Order No. 401/2016 was issued by the Ministry of Finance of Cyprus adopting the provisions for Country-by-Country (“C-b-C”) Reporting.

Every ultimate parent company of a multinational group of companies that is tax resident of Cyprus must submit a C-b-C Report within 15 months of the end of its financial year. The report must include the following information for each country (whether E.U. or non-E.U.) where the group is operating:

- Revenues
- Profits before taxation
- Tax actually paid and tax payable
- Issued share capital
- Accumulated reserves
- Number of employees
- Tangible assets (other than cash or cash equivalents)

An “ultimate parent company” is a company which meets the following criteria:

- The company holds, directly or indirectly, enough share capital in one or more other companies in the multinational group so that it is required to prepare consolidated financial statements in accordance with the accounting principles followed in the country in which it is resident.
- There is no other company in the multinational group that directly or indirectly holds share capital in the first company which would oblige such other company to prepare consolidated financial statements.

Under certain circumstances, a Cypriot tax resident holding company may be obliged to submit the report even if it is not the ultimate holding company.

Groups with gross annual consolidated revenues of less than €750 million are exempt from this obligation.

### **B.E.P.S. Action 15**

Cyprus is a signatory to the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting that is intended to implement a series of tax treaty measures in one fell swoop.

The M.L.I. applies in cases where both states are party to the M.L.I. The M.L.I. will not apply where only one of the contracting states is a party to it. Each signatory country will have the opportunity to express its reservations to any provision found in the instrument.



# MALTA

Author  
Dr. Stefan P. Gauci  
Malta

## 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 as subsequently refined by E.U. regulations and directives following its accession in 2004. The result is a unique body of pragmatic law with international application.

The Companies Act envisages three forms of commercial arrangements as vehicles for conducting business: the *partnership en nom collectif*, the *partnership en commandite*,<sup>1</sup> and the limited liability company. Each has its own particular features and advantages. The first two arrangements have decreased in popularity and have been largely replaced by the limited liability company, which is made attractive by the main features of (i) the limited liability of the shareholders<sup>2</sup> and (ii) the separate juridical personality that the limited liability company enjoys.

Generally, the limited liability company – whether private exempt or private non-exempt, single-member or public – is the vehicle for conducting any kind of business activity without territorial limitation.

In addition, Maltese law allows for the increased use of the S.I.C.A.V. and the I.N.V.C.O. as the more specific form of limited liability company undertaking the provision of particular regulated services within the financial services industry:

- 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 and reinsurance business.

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<sup>1</sup> Since joining the E.U., Maltese company law offers a fourth type of vehicle, the European Economic Interest Grouping (“E.E.I.G.”), which has very particular and special features compared to traditional commercial partnerships. Only 48 entities have been incorporated as E.E.I.G.’s under Maltese law between 2008 and 2019. There were no new registrations of E.E.I.G.’s between 2020 and 2022 with only a solitary registration in 2023. Only 45 E.E.I.G.’s are still active at the time of writing.

<sup>2</sup> Shareholders’ limitation of liability is not absolute. The liability is limited to the amount of the share-capital that is still unpaid by the shareholder in favor of the limited liability company. The corporate veil may be pierced by the courts of competent jurisdiction in specific cases, such as fraudulent trading.

- Securitization cell companies allow an infinite number of segregated cells to be established for the performance of securitization transactions.<sup>3</sup> The assets and liabilities of each cell are considered to be contained separately and distinctly within that cell and are protected from the general assets of the securitization company and the assets and liabilities of the other cells. Cells are not vested with separate juridical personality, which is vested in the securitization company (the core), itself. All cells are managed and administered by the board of directors of the securitization company or by holders of special mandates to manage and administer the securitization transaction executed by a particular cell.
- Shipping and aviation cell companies.

### **Capital Contribution Taxes**

A company is incorporated in accordance with the provisions of the Companies Act by registering its memorandum and articles of association with the Malta Business Registry. Maltese law does not prescribe any capital taxes upon incorporation, but does provide for a company registration fee, payable on the extent of the authorized share capital of the company in terms of applicable subsidiary legislation.<sup>4</sup> The fee ranges from a minimum of €100 (on the basis an authorized share capital not exceeding €1,500 or equivalent in any other currency) to a maximum of €1,900 when submitted electronically.<sup>5</sup>

In order to maintain corporate good standing, the directors and company secretary are obligated to submit an annual return in compliance with the Companies Act provisions. The return is filed for each anniversary of the company's incorporation. The annual return must be accompanied by an annual return fee, which ranges from €85 to €1,200, depending on the extent of the company's authorized share capital.<sup>6</sup>

It is perhaps worth noting that the Malta Business Registry has invested heavily in the digitalization of the document submission process, as part of a nationwide drive to digitalize government departments and agencies and provide as many online services as is reasonably possible. While manual submissions are still accepted by the Malta Business Registry, it is likely a matter of when, not if, manual submissions will be phased out.

Simultaneously with the company's annual return, the directors and secretary of the company have an obligation to submit an Annual Confirmation B.O. form in compliance with the Companies Act (Register of Beneficial Owners) Regulations (the

<sup>3</sup> Despite gaining quite some popularity until 2018, interest has dwindled over the years and no new securitization vehicles have been incorporated and established since 2018.

<sup>4</sup> One ought to note that Maltese company legislation is heavily influenced by English company law; hence the inherited concept of authorized and issued share capital (a distinction that might be alien to other jurisdictions, especially those based on continental law).

<sup>5</sup> Higher registration fees ranging between €245 (on the basis of an authorized share capital, not exceeding €1,500 or equivalent in other currency) and €2,250 are applicable if the incorporation documents are submitted manually.

<sup>6</sup> Higher registration fees ranging between €100 (on the basis of an authorized share capital not exceeding €1,500 or equivalent in other currency) and €1,400 are applicable if the annual return is submitted manually.

“B.O. Regulations”). The form is required in specific circumstances as confirmation of the identity of the ultimate beneficial owners of the company, thereby ensuring that the company’s register of beneficial owners and the Register of Beneficial Owners maintained by the Malta Business Registry are updated on a regular basis. Likewise, it is mandatory that any changes to the beneficial ownership of the company during the course of the year must be reported to the Malta Business Registry within statutory deadlines. There are no annual statutory fees to be paid under the B.O. Regulations, in comparison to the annual return submission fee required under the Companies Act provisions.

The importance of compliance with the provisions of the B.O. Regulations should not be underestimated. Hefty penalties or imprisonment (or both penalty *and* imprisonment) may be incurred for late filing of the appropriate forms. Additionally, the Registrar of Companies may seek the striking of a company off the Register of Companies for persistent lack of compliance with the B.O. Regulations. Any assets belonging to companies that are struck off the Register of Companies due to violation of the terms of these regulations will devolve in favor of the Maltese government. Nonetheless, it is possible for the shareholders, or any person that demonstrates a legitimate interest, to seek the restoration of the company to the Register of Companies through a court proceeding, so long as the company is brought into good standing and all penalties have been paid in full.

The importance that is attributed to compliance with the B.O. Regulations is further highlighted by the number of inspections that are conducted by the Malta Business Registry on a yearly basis. The intent is to educate the industry on the requirements and the importance of compliance through monitoring and enforcement.

A similar obligation to maintain a Register of Beneficial Owners is imposed upon the directors and the company secretary by the Cooperation with Other Jurisdictions on Tax Matters Regulations.<sup>7</sup> Other penalties may be imposed for noncompliance. The Malta Tax and Customs Administration also conducts its own onsite and offsite inspections with respect to compliance with B.O. Regulations from a fiscal perspective. These inspections are conducted on a less frequent basis than those conducted by the Malta Business Registry.

### **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. However, with respect to companies engaging in licensed activities, such as the provision of investment services, the appointment of Maltese-resident directors may be required 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, listed companies, investment companies, and collective investment schemes. The guidelines are intended to promote a desired standard for members sitting on the board of directors of such companies. For private companies, the guidelines represent best practices and are recommended for the management and administration of larger private companies. Under amendments that were introduced in 2021, the directors of a private limited liability company are

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<sup>7</sup> S.L. 123.127 of the Laws of Malta

now required to provide the Malta Business Registry with a positive written declaration of their acceptance to be appointed to the board of directors; previously, this was only required in the case of public limited liability companies. In this respect, the gap between public and private limited liability companies has been narrowed from a governance perspective.

The directors of a Maltese company are personally responsible for the company's compliance with applicable legislation, and, in particular, compliance with Maltese tax law; directors of a Maltese registered company are personally liable for both direct and indirect taxes owed by the company. Although court decisions vary, the prevalent view is that the responsibility extends to all directors and officers of a company, including the company secretary and persons occupying managerial positions. Comparable liability is also imposed upon the liquidator of a company that is in the process of being wound up throughout the winding up process.

The Consolidated Group (Income Tax) Rules<sup>8</sup> allows a group of companies to submit a single, consolidated tax return covering all the companies within the group. A group of companies must satisfy two out of the following three conditions for forming a "fiscal unit." The parent company must be directly or indirectly entitled to at least

- 95% of the voting rights in the subsidiary company,
- 95% of the profits available for distribution to the ordinary shareholders of the subsidiary company, and
- 95% of the assets available for distribution to the ordinary shareholders of the subsidiary company upon a winding up.

In such a scenario where a fiscal unit exists, the parent company would be acting as the "principal taxpayer" with respect to any 95% subsidiary within the Group.

Additional personal responsibilities imposed on directors relate to the registration of employment contracts and the fulfillment of monthly and annual social security compliance requirements.

### **Audit Requirements**

In Malta, the preparation of mandatory audited financial statements is regulated by the Companies Act, the Maltese Income Tax Acts,<sup>9</sup> and the Accountancy Profession Act.<sup>10</sup> Financial statements are prepared in accordance with the International Financial Reporting Standards or under Maltese Generally Accepted Accounting Principles, as permitted by the Accountancy Profession Act and subsidiary legislation issued thereunder focusing on small and medium-sized enterprises ("S.M.E.'s").<sup>11</sup>

Generally, it is the directors' collective responsibility to maintain proper accounting records for the company, even if the accounting function is outsourced to third parties. This duty is owed by the directors to the shareholders due to the fact that

<sup>8</sup> Subsidiary Legislation 123.189 of the Laws of Malta.

<sup>9</sup> The Income Tax Act (Chapter 123 of the Laws of Malta) and the Income Tax Management Act (Chapter 372 of the Laws of Malta) are commonly referred to as the Income Tax Acts.

<sup>10</sup> Chapter 281 of the Laws of Malta.

<sup>11</sup> Subsidiary Legislation 281.05 of the Laws of Malta.



*“Specific fiscal incentives launched by the Maltese government in various business sectors include tax exemptions for royalty income derived from the exploitation of patents, copyrights, and trademarks registered in the name of a Maltese-resident company.”*

directorship carries with it responsibilities of a fiduciary nature towards the shareholders. Equally important is the fact that this duty extends to third parties who in good faith have entered into a contractual agreement with the company.

All companies are subject to a mandatory audit of their annual reports and financial statements, regardless of the volume of activities undertaken. It does not matter if a company is inactive, generating no turnover or income. Although entities such as stand-alone small companies<sup>12</sup> and small groups<sup>13</sup> of companies are not required to have their financial statements audited under company law, the Income Tax Acts still impose an audit requirement.

As a 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 and (ii) single-member companies. The Consolidated Group (Income Tax) Regulations<sup>14</sup> provide the criteria under which accounts may be consolidated.

### **Specific Industry Incentives**

The Maltese Aircraft Registry was launched in 2010, building on the success of the Maltese Shipping Registry, which was established in 1973. The Maltese Aircraft Registry continues to increase in its popularity as a sought-after registry, particularly in the sector of smaller jets for private business use. The Maltese government continues to invest resources towards strengthening this sector into one of the pillars of the Maltese financial services industry.

Specific fiscal incentives launched by the Maltese government in various business sectors include tax exemptions for royalty income derived from the exploitation of patents, copyrights, and trademarks registered in the name of a Maltese-resident company. The exemption for royalty companies is part of a government program to transform Malta into an intellectual property hub. The exemption applies to gaming companies operating from a base in Malta.

The Maltese government seeks to attract foreign investment into Malta, especially with respect to companies that may seek to relocate their strategic operations to Malta. Towards this end, Malta offers fiscal incentives to individuals who relocate to Malta for the purposes of employment under a qualifying contract, in eligible offices,

<sup>12</sup> Pursuant to Article 185(1) of the Companies Act, small companies cannot exceed two of the following thresholds, as reported on their balance sheets: (i) a balance sheet total of €2,562,310.74, (ii) a turnover of €5,124,621.48, and (iii) an average number of employees during the accounting period of 50; and small private companies cannot exceed two of the following thresholds: (i) a balance sheet total of €46,587.47, (ii) a turnover of €93,174.94, and (iii) an average number of employees during the accounting period of 2.

<sup>13</sup> Pursuant to Article 185(1) of the Companies Act, small groups of companies cannot exceed any of the following thresholds: (i) an aggregate balance sheet total of €2,562,310.74 net or €3,074,772.89 gross, (ii) an aggregate turnover of €5,124,621.48 net or €6,149,545.77 gross, and (iii) an aggregate number of employees of 50.

<sup>14</sup> Subsidiary Legislation 123.189.

held with companies registered under the laws of Malta.<sup>15</sup> This includes a 15% flat rate taxation for eligible individuals whose income is derived from a qualifying contract.

Through Malta Enterprise, fiscal and business assistance is provided to businesses that establish companies or factories on Maltese territory for production activities in sector-specific industries, as well as research and development.

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 or the Financial Institutions 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, including the Markets in Financial Instruments Directives (“M.i.F.I.D.” and “M.i.F.I.D II”), the Markets in Financial Instruments Regulation (“M.i.F.I.R.”), the Alternative Investment Fund Managers Directive (“A.I.F.M.D.”), the European Market Infrastructure Regulations (“E.M.I.R.”), and their variations promulgated from time to time.

Malta has been among the first jurisdictions to enact legislation providing a robust, yet flexible, regulatory framework for distributed ledger technology, cryptocurrencies, and artificial intelligence. The establishment of the Malta Digital Innovation Authority, closely followed by the enactment of the Innovative Technology Arrangements and Services Act and the Virtual Financial Assets Act (“V.F.A.”) towards the end of 2018, and the issuance of the first V.F.A. Licenses by the M.F.S.A. in 2019 paved the way for Maltese companies to enter into this new, fast-growing sector. It is expected that these innovations will continue to support the growth of the Maltese economy in the years to come.

In 2019, the Maltese Government sought to build on the successes achieved with respect to the distributed ledger technology and V.F.A. sectors by putting in motion the design of a national strategy in relation to Artificial Intelligence. A task force has been put together and a national strategy for A.I. in Malta 2030 has been published. A.I. continues to gain momentum in Malta with a number of foreign entities establishing a Maltese platform for international business and growth through A.I.

The latest legislative initiative has been in relation to the production of cannabis for medical and research purposes. It is a highly regulated sector, aimed at ensuring the safe production of cannabis in Malta for specific medical and health purposes. The legislation has attracted foreign interest in setting up research centers in Malta and is at the forefront of a sector that continues to gain momentum not only in Malta, but also internationally.

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<sup>15</sup> In this respect, one may refer to the Highly Qualified Persons Rules (Subsidiary Legislation 123.126), the Qualifying Employment in Innovation and Creativity (Personal Tax Rules, (Subsidiary Legislation 123.141 of the Laws of Malta), the Qualifying Employment in Aviation (Personal Tax) Rules (Subsidiary Legislation 123.168), and the Qualifying Employment in Maritime Activities and the Servicing of Offshore Oil and Gas Activities (Personal Tax) Rules (Subsidiary Legislation 123.182).



## **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, companies registered in Malta 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. Included are (i) bank interest, which may be taxed at the source at the rate of 15% upon an election to that effect by the taxpayer, (ii) investment income, which may be taxed at the rate of 15% at source, and (iii) gains from a real property transfer, which are taxed at source upon publication of the final deed of transfer. In the latter case, the tax is collected, on behalf of the Office of the Commissioner for Revenue, by the Notary Public publishing the deed of transfer.

The tax is levied on the taxable income of a company earned in the fiscal year being assessed, after accounting for deductible expenses that are wholly and exclusively incurred in the production of the income. Losses from prior years may be carried forward to offset the profits of the current year. Capital losses may not offset operating profits. Such losses may be used only to offset capital gains. The Income Tax Acts also allow for the benefit of group loss relief in those circumstances where the applicable criteria are met.

Malta applies the full imputation system of taxation, meaning that tax paid by a company is allowed as a credit when dividends are received by its shareholders.

Upon written request, companies that are in compliance with their tax submission and payment obligations may be furnished with a Fiscal Residence Certificate issued by the Office of the Commissioner for Revenue proving that their residence for tax purposes is Malta and, at the same time, confirming 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 following order of priority:

- Profits allocated to the final tax account
- Profits allocated to the immovable property account
- Distributions from the foreign income account
- Profits allocated to the Maltese taxed account
- Profits allocated to the untaxed account

## 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, all shareholders receiving the dividends are entitled to a refund of the tax paid by the company. Nonresident status is not a relevant factor in determining entitlement to the refund. 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.

*“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 a participation in another company.”*

### **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 a participation in another company. 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 nonresidents of Malta.

The Maltese government is currently considering significant amendments to the Income Tax Act. No further details other than the conceptualization of such amendments have been provided, but it is expected that some details will be provided towards the end of the year, with additional details to be announced yearly during the budget speech.

## EUROPEAN COMPLIANCE

The Maltese system of taxation has been the subject of lengthy and detailed discussions with the European Council and the Director-General for Competition regarding State Aid. It has also been discussed with the E.U. Member States within the Code of Conduct Group, consisting of representatives from the Finance Ministries and tax authorities of various Member States. The Code of Conduct Group identifies tax measures that are harmful under the Code of Conduct for business taxation. In the report submitted to the Economic and Financial Affairs Council (“E.C.O.F.I.N.”) in November 2016, the Code of Conduct Group concluded that the Maltese tax system is not harmful. Malta was and has consistently been transparent about its tax system: it is aimed at creating an attractive system that provides comparable benefits to domestic and foreign investors.

In addition, the European Council has not brought any cases against Malta related to a violation of the “four freedoms” or the principle of nondiscrimination. Malta has fully implemented and complied with all of the E.U.’s tax directives, which are unanimously approved by the Member States in E.C.O.F.I.N., and the Maltese tax system has not been found to infringe on the E.U.’s State Aid rules.

Globally, Malta has applied all O.E.C.D. initiatives to combat tax evasion, including the directives on mutual assistance between tax authorities, automatic exchanges of information, and the exchange of tax rulings and advance pricing arrangements in the field of transfer pricing. Malta is also an early adopter of the Common Reporting Standards and Country-by-Country Reporting obligations. Under Phase II of the O.E.C.D.’s Peer Reviews, Malta has been classified as “largely compliant” in matters of transparency and exchange of tax information.<sup>16</sup>

In June 2016, together with other Member States in E.C.O.F.I.N., Malta approved the Anti-Tax Avoidance Directive (“A.T.A.D.”). All Member States approved the A.T.A.D. 2 in February 2017. The A.T.A.D. entered into force as part of Malta’s body of law on January 1, 2019 (Subsidiary Legislation 123.187). Specific provisions dealing with exit taxation,<sup>17</sup> controlled foreign company (“C.F.C.”) rules, as well as a general anti-abuse provision, have also been introduced into Maltese law.

In sum, the debate revolves around the morality of setting up companies in a low-tax E.U. jurisdiction. These issues have already been addressed in detail by the E.C.J. in the Cadbury Schweppes decision. The E.C.J. held that anti-avoidance provisions such as C.F.C. provisions cannot hinder the fundamental freedom of establishment of the E.U., and that profits of a subsidiary in another Member State with a lower rate of taxation can only be taxed in the country of residence of the parent company if the subsidiary is wholly artificial.

On December 20, 2021, the O.E.C.D. published detailed rules to assist in the implementation of a landmark reform to the international tax system which will ensure multinational enterprises (“M.N.E.’s”) will be subject to a minimum tax rate of 15% from 2023. The Pillar Two model rules provide governments with a precise template for moving forward with the two-pillar solution to address the tax challenges arising from the digitalization and globalization of the economy, agreed to in October 2021 by 137 countries and jurisdictions under the O.E.C.D./G20 Inclusive Framework on B.E.P.S.

The Transfer Pricing Rules<sup>18</sup> have been in effect as of November 18, 2022.

The European Union Global Minimum Level of Taxation for Multinational Enterprise Groups and Large-Scale Domestic Groups Regulations<sup>19</sup> entered into force on December 31, 2023. The regulations introduced a global minimum corporate tax rate of 15% on entities located in Malta that are members of a multinational enterprise group or of a large-scale domestic group which has, among other criteria, an annual revenue of €750 million or more.

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<sup>16</sup> The United Kingdom, Germany, the Netherlands, and Italy received comparable clarification.

<sup>17</sup> Entered into force on January 1, 2020.

<sup>18</sup> S.L. 123.207 of the Laws of Malta.

<sup>19</sup> S.L. 123.212 of the Laws of Malta.

## 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 from a participation in a subsidiary, 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:
  - It is a resident of or incorporated in an E.U. Member State.
  - It is subject to foreign tax at a rate of at least 15%.
  - 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:
  - The equity holding is not a portfolio investment.<sup>20</sup>
  - 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 are 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
  - 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 other company.
- 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.<sup>21</sup>

<sup>20</sup> For this purpose, the holding of shares by a Maltese-resident company in a company not resident in Malta and that derives more than 50% of its income from portfolio investments is itself deemed to be a portfolio investment.

<sup>21</sup> To be considered a participation, the right to nominate members of the board of directors should be a majority right.

- A company is a shareholder in the target company and the value of its investment is at least €1,164,000 at the time of purchase. The investment must be held for at least 183 consecutive days.
- 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 purposes of a trade.

Gains or profits arising on the transfer of a participating holding derived by a company registered in Malta (the “transferor company”), shall only qualify for the exemption if such gains or profits would have been exempt had the transfer of the holding been made by the beneficial owner of the transferor company. Where there is more than one beneficial owner, and gains or profits made by one or more shareholders thereof would be exempt (the “exempt beneficial owner”) and others would not be exempt, the exemption shall apply to that part of the gain or profit to which the exempt beneficial owner is beneficially entitled.

Under an anti-abuse rule, where the transferor company has claimed the exemption described in the preceding paragraph on the whole or part of the gains or profits, and any person who would not have qualified for the exemption (the “non-qualifying shareholder”) thereafter becomes beneficially entitled to some or all of the gains or profits – or to a larger part thereof than was the case at the time the gains or profits arose – such untaxed gains or profits, or additional part thereof to which the non-qualifying shareholder becomes entitled shall be taxed at the rate referred to in Article 56(6). Such tax shall constitute tax payable by the company in the year of assessment in respect to which such person shall become entitled to such profits, even prior to their distribution.

The participation exemption does not apply to income derived from a participation in a company that is resident for tax purposes in a jurisdiction included in the E.U. list of noncooperative jurisdictions for a minimum period of three months during the year immediately preceding the year of assessment, unless it is proved to the satisfaction of the Commissioner that the company carries on sufficient significant people functions in that jurisdiction that are commensurate with the income realized by the company. Where such three months are consecutive and fall in two subsequent consecutive basis years, the exemption shall not apply in respect to any such income derived in any one of the two years.

## OTHER EXEMPTIONS

Other exemptions apply, the most important of which include the following:

### **Permanent Establishment**

Income or gains derived by a company resident in Malta are exempt from Maltese taxation if attributable to a permanent establishment situated outside of Malta. The exemption covers income from ongoing operations and gain from 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.<sup>22</sup>

In the case of distributed profits received from a participation by a parent company that is resident in Malta, or a permanent establishment in Malta of a company that is resident in another E.U. Member State, the participation exemption applies only to the extent the distribution is not deductible by the payor.

### **Intellectual Property**

Royalties, advances, and similar income derived from patents, copyrights, or 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.

## **WITHHOLDING TAXES ON DIVIDENDS DISTRIBUTED**

No withholding taxes are levied on dividend distributions to a nonresident shareholder, provided that the shareholder is not directly or indirectly owned and controlled by, and does not act on behalf of, an individual who is ordinarily resident and domiciled in Malta.

## **WITHHOLDING TAXES ON INTEREST PAID**

No taxes are levied on interest payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the interest is effectively connected therewith. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

## **WITHHOLDING TAXES ON ROYALTIES PAID**

No taxes are levied on royalty payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the royalty payment is effectively connected with that permanent establishment. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.



<sup>22</sup>

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.

## 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 nonresident with regard to 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 if the company owns immovable property in Malta.

Similar exemptions from stamp duty and income tax liability apply when the value of the ownership is shifted from one shareholder to another shareholder by way of the issuance of shares by the company. The value of the ownership is represented by the percentage share capital held or the voting rights held in the company. In terms of Maltese law, these are considered as deemed transfers.

## 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.
- 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 tax treaty network is made up of treaties in force with more than 80 states. These treaties are by and large modeled after the O.E.C.D. Model Convention provisions and treaty interpretations as per the Commentaries. The countries within Malta's double tax treaty network are listed below.

|            |         |               |              |
|------------|---------|---------------|--------------|
| Albania    | Finland | Libya         | Serbia       |
| Andorra    | France  | Liechtenstein | Singapore    |
| Armenia    | Georgia | Lithuania     | Slovakia     |
| Australia  | Germany | Luxembourg    | Slovenia     |
| Austria    | Ghana*  | Malaysia      | South Africa |
| Azerbaijan | Greece  | Mauritius     | South Korea  |

|                |             |              |                      |
|----------------|-------------|--------------|----------------------|
| Bahrain        | Guernsey    | Mexico       | Spain                |
| Barbados       | Hong Kong   | Moldova      | Sweden               |
| Belgium        | Hungary     | Monaco       | Switzerland          |
| Botswana       | Iceland     | Montenegro   | Syria                |
| Bulgaria       | India       | Morocco      | Tunisia              |
| Canada         | Ireland     | Netherlands  | Turkey               |
| China          | Isle of Man | Norway       | Ukraine              |
| Croatia        | Israel      | Pakistan     | United Arab Emirates |
| Curaçao*       | Italy       | Poland       | United Kingdom       |
| Cyprus         | Jersey      | Portugal     | United States        |
| Czech Republic | Jordan      | Qatar        | Uruguay              |
| Denmark        | Kosovo      | Romania      | Vietnam              |
| Egypt          | Kuwait      | Russia       |                      |
| Estonia        | Latvia      | San Marino   |                      |
| Ethiopia       | Lebanon     | Saudi Arabia |                      |

\* The double taxation treaties with Curaçao and Ghana are not yet in force as of July 1, 2024.

The double taxation treaties with Bosnia and Herzegovina, Oman, and Thailand are currently in various stages of negotiation.

Malta has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which automatically amended a number of existing double taxation treaties with regard to exchange of information.<sup>23</sup>

### **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 its 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.
- 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.

<sup>23</sup> Affected treaties include the treaties with Albania, Andorra, Australia, Austria, Barbados, Belgium, Canada, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Greece, Guernsey, Hungary, Iceland, India, Ireland, Isle of Man, Israel, Jersey, Jordan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malaysia, Mauritius, the Netherlands, Norway, Pakistan, Portugal, Qatar, Russia, San Marino, Saudi Arabia, Serbia, Singapore, Slovakia, Slovenia, Spain, South Korea, Sweden, Ukraine, the United Kingdom, and Uruguay.



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 all 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.
- Documentary evidence is made available that is satisfactory to the Commissioner for Revenue 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 close 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, which includes cooperation in foreign tax-related matters. It was one of the first states to enter into an intergovernmental agreement with the United States to allow for the implementation of F.A.T.C.A.<sup>24</sup> Maltese implementation of the F.A.T.C.A. provisions was published on March 7, 2014.<sup>25</sup> The first exchanges between the two states under the I.G.A. took place in the third quarter of 2015.

Malta is also an active participant in the B.E.P.S. Project. It is a member of the ad hoc group of countries mandated by the O.E.C.D. and the G-20 in February 2015 to complete work on B.E.P.S. Malta signed the Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting (the “M.L.I.”) on June 7, 2017. The M.L.I. was transposed in Maltese legislation on April 27, 2018.<sup>26</sup>

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.

<sup>24</sup> Malta and the U.S. signed a Model 1 I.G.A. on December 16, 2013.

<sup>25</sup> See Exchange of Information (United States of America) (F.A.T.C.A.) Order, Subsidiary Legislation 123.156.

<sup>26</sup> See Multilateral Convention (Implementing Tax Treaty Measures to Prevent Base Erosion and Profit Shifting) Order, Subsidiary Legislation 12.183.



The E.U. Administrative Cooperation Directive (Council Directive 2011/16/E.U. of February 15, 2011 on administrative cooperation in the field of taxation) was adopted into Maltese law effective July 22, 2011. Following amendments that were made via Council Directive (E.U.) 2018/822 (“D.A.C.6”), as of 2018 intermediaries and, in certain circumstances, relevant taxpayers became obliged to provide information to tax authorities of E.U. Member States relating to reportable cross-border arrangements.

Council Directive (EU)2021/514 (“D.A.C.7”) extends the E.U. tax transparency rules to digital platforms and introduces an obligation for digital platform operators to provide information on income derived by sellers through their platforms. This Directive enters into force from 2023 onwards. The information collected will be shared with the tax authorities of the concerned Member States with the aim of addressing a lack of tax compliance and the under-declaration of income earned from commercial activities carried out with the intermediation of such digital platforms.

It is expected that the advent of D.A.C.7 may lead to a future proposal for an E.U. Council directive, already styled “D.A.C.8.” The proposal will likely seek to enlarge and widen the exchange of information framework in the field of taxation and include crypto-assets and e-money.

Malta is an early adopter of the Common Reporting Standard and is expected to submit its first report by the end of June 2017, focusing on the financial year ending on December 31, 2016.

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).

In compliance with the E.U.’s Fourth Anti Money-Laundering Directive,<sup>27</sup> Malta has implemented the Ultimate Beneficial Ownership Register via the enactment of the Companies Act (Register of Beneficial Owners) Regulations (the “B.O. Regulations”).<sup>28</sup> The Ultimate Beneficial Ownership Register is maintained by the Malta Business Registry as a central registry on the national level, whilst the directors of companies have a corresponding obligation to maintain their own corporate beneficial ownership register on an individual corporate basis. Regular inspections are conducted by the Malta Business Registry to ensure that every company is compliant with the requirements of the B.O. Regulations and that there is the level of transparency with respect to beneficial ownership that is demanded by international best practices. Failure to comply with the B.O. Regulations may lead to the imposition of administrative penalties, imprisonment, or both. Persistent noncompliance may lead to the striking of a company off the Registry of Companies with all its assets devolving upon and in favor of the government of Malta. A court process can be initiated by interested parties (primarily the shareholders) to have the company

<sup>27</sup> See Directive (E.U.) 2015/849 of the European Parliament and of the European Council of May 20, 2015.

<sup>28</sup> See Subsidiary Legislation 386.19. These regulations were enacted as part of wider legislation creating separate Ultimate Beneficial Ownership Registers for the purposes of the Trusts and Trustees Act (Subsidiary Legislation 331.10) and the Civil Code with respect to foundations (Subsidiary Legislation 16.15), all intended to ensure compliance with the provisions of the Fourth and Fifth Anti-Money Laundering Directive.

restored to the Registry of Companies, provided all accrued penalties have been paid by the directors, any aspects of noncompliance have been remedied, and the company has been brought back into good standing.

Under the relevant provisions of the Cooperation with Other Jurisdictions on Tax Matters Regulations, companies are required to maintain a different and separate beneficial ownership register (though largely identical to the beneficial ownership register in terms of the B.O. Regulations). Similarly, inspections by the Office of the Commissioner for Revenue may be conducted for the purpose of ascertaining compliance with these obligations and penalties may be imposed if the company is found to be noncompliant.

The Fifth Anti Money-Laundering Directive has also been implemented and entered into force. The Sixth Anti Money-Laundering Directive is in the pipeline. The text of the new E.U. Anti Money-Laundering Regulation and the establishment of supranational anti money-laundering regulations at the E.U. level is expected by the end of 2023, for implementation in 2024.

## PATENT BOX REGIME

The Patent Box Regime (Deduction) Rules were introduced in 2019 to provide a basis on which the deduction may be claimed and shall apply in relation to qualifying income derived from qualifying intellectual property (“Qualifying I.P.”) on or after January 1, 2019. Qualifying IP generally comprises the following assets:

- Patents whether issued or pending, provided that where a pending patent is eventually rejected, such patent is deemed to have never constituted Qualifying I.P.
- Assets in respect of which protection rights are granted in terms of national, European or international legislation; utility models; or software protected by copyright under national or international legislation.
- In the case of a small entity (as defined in the Rules), other I.P. assets that are non-obvious, useful, novel and have similar features to patents, provided that certification is obtained by Malta Enterprise.

The Rules specifically exclude marketing related I.P. assets such as brands, trademarks and trade names from Qualifying I.P.

The deduction applies only upon the satisfaction of the following criteria:

- The research, planning, processing, experimenting, testing, devising, designing, development or similar activities leading to the creation, development, improvement or protection of the Qualifying I.P. is carried out wholly or in part by the Beneficiary, alone or with any other person(s) or in terms of cost sharing arrangements with other persons, whether these are resident in Malta or otherwise.<sup>29</sup>

<sup>29</sup> Such activities include, *inter alia*, (i) functions performed by employees of other enterprises, which employees are acting under specific directions of the Beneficiary (in a manner equivalent to that of employees of such Beneficiary) and (ii) functions carried out through a permanent establishment (including a branch) situated in a jurisdiction other than the jurisdiction of residence of the beneficiary, to the extent that such permanent establishment derives income which is subject to tax in the jurisdiction of residence of the Beneficiary.

**“The Rules specifically exclude marketing related I.P. assets such as brands, trademarks and trade names from Qualifying I.P.”**

- The Beneficiary is the owner, co-owner, or holder of an exclusive license in respect of, the Qualifying I.P.
- The Qualifying I.P. is granted legal protection in at least one jurisdiction.
- The Beneficiary maintains sufficient substance in terms of physical presence, personnel, assets or other relevant indicators in the relevant jurisdiction in respect of the Qualifying I.P.
- Where the Beneficiary is a body of persons, it is empowered to receive such income.
- The request for such deduction is included in the Beneficiary's tax return.

## CONCLUSIONS APPLICABLE TO MALTA

The legal framework in Malta offers several key advantages for those seeking to conduct international business in a sound and reputable jurisdiction.

Maltese transfer pricing rules are relatively flexible, and there are no thin capitalization rules. Several anti-abuse rules are contained in Article 51 of the Income Tax Act and Malta now applies the general anti-abuse provision in the A.T.A.D. designed to combat artificial and fictitious schemes.

The legislation in Malta permits companies to migrate to and from Malta as long as certain minimum requirements are fulfilled. Branches of overseas companies enjoy the same tax treatment applicable to companies incorporated in Malta. Incorporation and winding up procedures are relatively easy and in general quite expeditious.



## About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

Our firm provides a wide range of tax planning and commercial legal services to clients across the Americas, Asia, Europe, and the Middle East. Clients include global investors, multinational corporations expanding into the U.S., and U.S. businesses with international operations. Our core practice focuses on cross-border transactions.

## About Insights

*Insights*, the tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

## Location

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Architects and Designers Building | 150 East 58th Street, 22nd Floor | New York, New York 10155

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63 Rotschild Boulevard, Suite 207 | Tel Aviv, Israel 6578510

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## Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

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|                      |  |                       |
|----------------------|--|-----------------------|
| Galia Antebi         | <a href="mailto:antebi@ruchelaw.com">antebi@ruchelaw.com</a>         | +972 52.258.5161      |
| Michael Bennett      | <a href="mailto:bennett@ruchelaw.com">bennett@ruchelaw.com</a>       | +1 212.755.3333 x 123 |
| Nina Krauthamer      | <a href="mailto:krauthamer@ruchelaw.com">krauthamer@ruchelaw.com</a> | +1 212.755.3333 x 118 |
| Wooyoung Lee         | <a href="mailto:lee@ruchelaw.com">lee@ruchelaw.com</a>               | +1 212.755.3333 x 121 |
| Michael Peggs        | <a href="mailto:peggs@ruchelaw.com">peggs@ruchelaw.com</a>           | +1 212.755.3333 x 232 |
| Simon H. Prisk       | <a href="mailto:prisk@ruchelaw.com">prisk@ruchelaw.com</a>           | +1 212.755.3333 x 114 |
| Neha Rastogi         | <a href="mailto:rastogi@ruchelaw.com">rastogi@ruchelaw.com</a>       | +1 212.755.3333 x 131 |
| Stanley C. Ruchelman | <a href="mailto:ruchelman@ruchelaw.com">ruchelman@ruchelaw.com</a>   | +1 212.755.3333 x 111 |

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## Editorial Staff

Stanley C. Ruchelman ..... Editor in Chief  
Francesca York ..... Graphic Designer

### WITH PHOTOS BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.

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