OUTBOUND ACQUISITIONS:
EUROPEAN HOLDING COMPANY STRUCTURES

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TABLE OF CONTENTS

1. Introduction 1
2. Luxembourg 5
   A. General/Participation Exemption 6
      i. Dividends 7
      ii. Capital Gains 8
   B. Subject to Tax 8
   C. Dividends or Capital Gains after Share Exchange 8
   D. Luxembourg Permanent Establishment 9
      i. Partial Participation Exemption 9
   E. Withholding Tax in Foreign Subsidiary's Country 9
   F. Deduction of Costs 10
      i. Write-offs 10
      ii. Financial Costs 11
      iii. Liquidation Losses 11
   G. Withholding Tax on Outbound Dividends/Capital Gains 11
      i. Dividend Payment 11
      ii. Interest Payment on (Hybrid) Debt 12
   H. Capital Gains in Hands of Shareholders 12
   I. Liquidation of a S.O.P.A.R.F.I. 13
   J. Repurchase of Shares in a S.O.P.A.R.F.I. 13
   K. Other Tax Issues 13
      i. Debt/Equity Ratio 13
      ii. Capital Duty 13
      iii. Annual Net Worth Tax 14
   L. S.I.C.A.R. 14
   M. Securitization Vehicle 15
3. Denmark 16
   A. In General 16
   B. Corporate Income Tax 18
   C. Withholding Tax in Foreign Subsidiary's Country 18
   D. Corporate Taxation of Inbound Dividends 19
   E. C.F.C. Taxation 20
      i. C.F.C. 20
   F. Capital Gains Taxation 21
   G. Interest Deductibility Limitations 22

i. Thin Capitalization....22
ii. Additional Limitations....23
iii. Calculation of Net Financial Expense....23
iv. Restrictions under the Asset Limitation Rule....24
H. Withholding Tax on Outbound Dividends....25
I. Tightening of the Danish Rules for Exemption of Danish Dividend Withholding Tax....25
J. Interest Withholding Tax and Check-the-Box Countermeasures....26
K. Transfer Pricing....27
L. Group of Companies – Joint Cross Border Taxation....28
M. Interim Dividends....29
N. Binding Advance Ruling....30
4. Switzerland....30
A. In General....30
B. Taxation of Holding Companies....30
i. Corporate Income Tax....30
ii. Corporate Wealth Tax....31
iii. Stamp Duty at Formation....31
iv. Stamp Duty upon Capital Contributions....32
v. Capital Gains Tax....32
vi. Value-Added Tax ("V.A.T.")....32
vii. Securities Turnover Tax....32
viii. Swiss Withholding Tax....33
ix. Tax Credit for Foreign Withholding Taxes....34
x. Swiss Tax Treaty Network....34
xi. 1962 Decree on Misuse of Treaties....34
xii. 1998 Circular Letter....34
xiii. Special Rule for Companies with Contacts in the U.S.....35
xiv. Holding Company Activities....35
C. Additional Tax Related Issues....35
i. U.S. Check-the-Box Rules....35
ii. Swiss Ruling Policy....36
iii. Swiss Debt-Equity Rules....36
iv. Use of Swiss Holding Companies....36
v. Future Taxation of Swiss Holding Companies....37
5. Belgium....38

A. Corporate Income Tax 38
i. General Regime 38
ii. Participation Exemption – General 38
iii. Dividends Received Deduction 38
a. Minimum Value of Participation 40
b. Minimum Holding Period 40
c. Subject to Comparable Tax 41
d. Proscribed Business Activities 42
e. Offshore Activity 43
f. Certain Foreign Branch Income 43
g. Intermediary Companies 43
h. Purchased Dividend 44
i. Other Aspects 44
j. Ruling Practice 45
iv. Capital Gain Exemption 45
a. No Minimum Ownership; One Year Holding Period Requirement 45
b. Options 46
c. Unrealized Gains 47
d. Capital Losses 47
e. Deductible Expenses 47
B. Withholding Tax on Distributions 48
i. To Belgium 48
ii. From Belgium 48
iii. *Denkavit* Case 49
iv. Liquidation and Redemption Distributions 49
C. Withholding Tax on Outbound Interest Payments 50
D. Capital Duty 50
E. V.A.T. 50
F. Private P.R.I.C.A.F. 51
6. The Netherlands 52
A. Corporate Income Tax – General 52
B. Participation Exemption 52
i. In General 52
ii. Motive Test 53
iii. Subject-to-Tax Test 54

iv. Asset Test ... 54
v. Earn-Out and Balance Guarantee Arrangements ... 55
vi. Expiring Participation ... 55
vii. Non-Qualifying Participations ... 55
viii. Stock Options/Convertible Bonds ... 55
ix. Hybrid Loans/Profit Rights ... 55
C. Other Aspects ... 56
i. Costs/Expenses ... 56
ii. Base Erosion ... 56
iii. Excessive Debt Financing for Holding Companies ... 57
iv. Dutch Acquisition Holding Company ... 58
v. Innovation Box ... 58
vi. Capital Losses ... 59
D. Tax Rulings ... 59
E. Dividend Withholding Tax ... 59
F. Extra-Territorial Taxation and Anti-Abuse Rules ... 60
G. Capital Tax/Stamp Duties ... 61
7. Spain ... 61
A. Exemption on Qualified Foreign Source Income ... 62
B. Qualified Foreign Investments ... 62
i. Minimum Participation and Holding Period ... 62
ii. Subject to and Not Exempt from Tax ... 63
iii. Active Nonresident Subsidiary ... 63
iv. Qualified Holding Company ... 64
v. Corporate Purpose ... 64
vi. Material and Human Resources ... 64
vii. Filing with the Spanish Tax Authorities ... 65
viii. Deduction of Costs ... 65
ix. Deduction of Goodwill on Foreign Subsidiaries ... 65
C. Liquidation Losses ... 66
D. Exemption of E.T.V.E. Dividend Distributions ... 66
E. Capital Gains on Transfer of E.T.V.E. ... 67
F. Liquidation of an E.T.V.E. ... 67
G. Other Income Tax Issues ... 67
H. Corporate Income Tax ... 68
i. Rate ... 68

ii. Interest Barrier Rule ... 68
iii. Capital Duty ... 68
iv. Transfer Pricing ... 68
v. Controlled Foreign Corporation ... 69
8. Ireland ... 70
A. Corporate Tax Rate ... 70
B. Dividends Received by Irish Companies ... 71
C. Dividends Paid by Irish Holding Companies ... 72
D. Exemption from Capital Gains Tax on Sale of Foreign Shares ... 73
E. Financing the Irish Holding Company – Interest Payment Deductions ... 73
F. Financing of the Irish Holding Company – Interest Withholding Tax ... 74
G. Treaty Network ... 75
H. Capital Duty ... 75
I. Stamp Duty on Shares ... 75
J. Liquidation Distributions by the Holding Company ... 76
K. Thin Capitalization/Transfer Pricing/C.F.C. Rates ... 76
L. Relevant Anti-Avoidance Provisions ... 76
M. Conclusion ... 76
9. United Kingdom ... 76
A. Introduction ... 76
B. Corporate Tax Rate ... 79
C. Dividends Received By U.K. Companies ... 80
D. Foreign Tax Credit ... 80
i. Source of Income ... 81
ii. Mixer Companies and Pooling ... 81
iii. Anti-Avoidance ... 82
iv. Hybrid Instruments ... 83
E. Dividends Paid By U.K. Companies to U.S. Shareholders ... 83
F. Capital Gains Tax Exemption on the Disposal of Operating Company Shares ... 83
G. Substantial Shareholding ... 83
H. Trading Company Limitations ... 84
I. Capital Gains on the Disposal by Nonresidents of Shares in U.K. Companies ... 85
J. Capital Tax and Stamp Duty ... 85
K. Tax Treaty Network ... 85
L. Debt Financing of U.K. Companies ... 86

M. Anti-Arbitrage Legislation 87
N. Worldwide Debt Cap 88
O. Controlled Foreign Companies 89
i. Background 89
ii. Overview of Current Regime 89
iii. C.F.C. Rules Apply to Profits, not Gains 90
iv. Taxation of Foreign Branches of U.K. Companies 91
P. The U.K. – U.S. Double Tax Treaty 91
Q. Value Added Tax (“V.A.T.”) 92
R. General Anti Abuse Rule ("G.A.A.R.") 93
S. Foreign Account Tax Compliance Act ("F.A.T.C.A.") – U.K. implications 94
i. Background to the U.K. Implementation of F.A.T.C.A. in Domestic Legislation 94
ii. Implementation of the I.G.A. 94
iii. The I.G.A. - Implications 94
10. Austria 95
A. Introduction 95
B. Capitalization of Austrian Companies 96
i. Equity Contributions 96
ii. Loan Capital 96
C. Corporate Taxation 96
i. In General 96
ii. Participation Exemption 97
a. Participation Exemption for Dividends Received from Austrian Corporations and Portfolio Participations in Foreign Corporations 97
b. Participation Exemption for Qualifying International Participations 97
1) Qualifying International Participations 97
2) Tax Exemptions 97
3) Capital Gains 98
4) Anti-avoidance Provisions 98
5) Treaty Exemptions 99
c. Interest Deduction 100
iii. Group Taxation 100
D. Withholding Tax on Outbound Payments 101
i. Dividend Payments 101

		ii.	Capital Gains	102
		iii.	Royalties	102
		iv.	Interest	103
		v.	Other Income	104
	E.	Other Tax Issues		104
		i.	Wealth Tax	104
		ii.	Anti-Avoidance Legislation	104
		iii.	Foreign Tax Credit	104
11.	France			105
	A.	Corporate Income Tax ("C.I.T.") – General		105
	B.	Net Operating Losses ("N.O.L.s")		106
		i.	Carryforward	106
		ii.	Carryback	106
	C.	Participation Exemption or D.R.D on Dividends		106
	D.	Tax Consolidation		108
	E.	Special contribution on distributions		109
	F.	Withholding Tax ("W.H.T.") on Dividends		109
		i.	Outbound Dividends Within the E.U.	109
			a. E.U. Directive Exemption	109
			b. 5% E.U. Exemption	110
		ii.	Outbound Dividends Outside E.U.	111
		iii.	Dividends from Foreign Subsidiaries	111
	G.	Capital Gains Tax on Shareholdings – Exemption.		111
	H.	Other Tax Items		113
		i.	Deductibility of Interest Charge	113
			a. Limitation for holding companies	113
			b. Thin Capitalization	114
		ii.	Withholding Tax on Interest – Exemptions	116
			a. Interest on Loans	116
			b. Interest on Bonds	117
			c. Interest Paid to an E.U. Related-Company	117
		iii.	C.F.C. Legislation	118
		iv.	Transfer Pricing	119
		v.	N.C.C.T.	120
		vi.	Financial Transaction Tax ("F.T.T.")	120
		vii.	Transfer Taxes	121

12. Italy 122
A. Corporate Tax Rate 122
B. Dividend Exemption 122
i. Domestic Dividends 122
ii. Foreign Dividends 122
C. Participation exemption for Gains 123
D. Interest Deduction 123
E. Minimum Taxable Income for Non-operating Companies 124
F. Group Consolidation 125
i. Domestic Consolidation 125
ii. Worldwide Consolidation 126
G. C.F.C. Legislation 126
H. The New "White-List" of Countries and Territories 128
I. Treaty Protection 128
J. Withholding Taxes on Outbound Payments 128
i. Dividend Withholding – Domestic Law 128
ii. Parent/Subsidiary Directive 128
iii. Interest and Royalties 129
iv. Nonresident Shareholder with a Permanent Establishment 129
v. Nonresident Shareholder – No Permanent Establishment 130
K. Foreign Tax Credit 130
L. Allowance for Corporate Equity ("A.C.E.") 130
13. Germany 132
A. Introduction 132
B. General Taxation of German Corporate Entities 132
C. General participation and Dividend Exemption 132
i. Background 132
ii. Participation Exemption 133
iii. Dividend Exemption 134
iv. Financing Expenses 134
D. Trade Tax Add-Backs and Deductions 135
E. Earnings Stripping Rules 136
i. General Concept 136
ii. Exemptions 136
F. Loss Carryforward 137
G. C.F.C. Taxation 137

H. Dividend Withholding Tax ... 138
I. Transfer Pricing ... 139
i. German Administrative Principles ... 139
ii. Transfer of Functions ... 140
14. Sweden ... 141
A. In General ... 141
B. Participation exemption ... 141
i. General ... 141
ii. Dividends ... 142
iii. Capital Gain ... 142
iv. Qualifying Foreign Entities ... 143
C. Withholding tax ... 143
i. Outbound Dividends ... 143
ii. Inbound Dividends ... 143
iii. Treaty Chart ... 144
D. Financing ... 144
i. Loan Financing ... 144
ii. Equity Contributions ... 145
E. Liquidation ... 145
i. Distributions ... 145
ii. Losses ... 145
F. Net Operating Losses ... 146
G. Transfer Pricing ... 146
H. Controlled Foreign Corporation – C.F.C. ... 147
15. Cyprus ... 147
A. General ... 147
B. Income Tax ... 149
i. Tax Rate ... 149
ii. Residence ... 149
iii. Permanent Establishment ... 149
iv. Income Subject to Tax ... 150
v. Expanded Definition of Securities ... 150
vi. Tax Losses - Group Relief ... 151
vii. Reorganization of Companies ... 151
viii. Specific Income Tax Benefits ... 151
ix. Specific Allowances and Deductions ... 152

x. Amendments to the Cyprus Income Tax Law 152
xi. Penalties 152
C. The Special Contribution for the Defense of the Republic Law 152
i. In General 152
ii. Penalties 153
D. Other Taxes 153
E. Changes in Tax Registration Provisions 153
F. Exchange of Information and Bank Confidentiality Rules 153
G. More Stringent Requirements from Various E.U. Jurisdictions 154
H. Double Tax Treaties 155
16. Malta 155
A. Introduction 155
B. Taxation of Company Profits 156
C. Tax Accounting 156
D. The Maltese Refundable Tax System 157
E. Transfer of Shares in a Malta Company 158
F. Double Taxation Relief 158
i. Treaty Relief 158
ii. Unilateral Relief 160
iii. Flat Rate Foreign Tax Credit 160
G. Conclusion Applicable to Malta 161
17. Conclusion 161

1. INTRODUCTION

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

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

Nonetheless, the use of a holding company can provide valuable tax saving opportunities when profits of the target company are distributed. The use of a holding company may reduce foreign withholding taxes that may be claimed as foreign tax credits by the U.S. parent. This can result in substantial savings if the operating and tax costs of maintaining the holding company are significantly less than the withholding taxes being saved.

Although the foreign tax credit is often described as a "dollar-for-dollar reduction of U.S. tax" when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality is quite different. Only taxes that are imposed on items of "foreign source taxable income" may be claimed as a credit.[3] This rule, known as "the foreign tax credit limitation," is intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S. taxable income. The U.S., as do most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income. It also prevents so-called

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

2 There are exceptions to the general characterization of a dividend as an item of Foreign Personal Holding Company Income that might apply. One relates to dividends received from a related person which (i) is a corporation created or organized under the laws of the same foreign country as the recipient C.F.C. and (i) has a substantial part of its assets used in its trade or business located in that foreign country. See Code §954(c)(3)(A)(i). For a temporary period of time, a look-through rule is provided in Code §954(c)(6) under which dividends received by a C.F.C. from a related C.F.C. are treated as active income rather than Foreign Personal Holding Company Income to the extent the earnings of the entity making the payment are attributable to active income. This provision terminated at the beginning of 2012.

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

"cross crediting" under which high taxes on operating income may be used to offset U.S. tax on lightly taxed investment income. For many years, the limitation was applied separately with regard to eight different categories of baskets of income designed to prevent the absorption of excess foreign tax credits by low tax foreign source income. In substance, this eviscerated the benefit of the foreign tax credit when looked at on an overall basis. The problem has been eased now because the number of foreign tax credit baskets has been reduced from eight to two, passive and general. On the other hand, the Administration's tax proposals would impair the ability of U.S. based multinational groups to choose whether to receive dividends from highly taxed or lightly taxed foreign corporations by putting all earnings and all taxes of foreign subsidiaries into common pools so that only a blended rate of foreign tax may be claimed as a foreign tax credit.

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

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

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

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

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

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

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

This form of "self-help" is no longer available as a result of the inversion rules of Code §7874. In some circumstances, Code §7874 imposes tax on inversion gains and that tax cannot be reduced by credits or net operating loss carryforwards. In other circumstances, §7874 treats the foreign corporation as if it were a U.S. corporation.

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

For multinational groups held by fiscally transparent entities in the U.S., such as L.L.C.'s, U.S. law changed in 2013 for the non-corporate members of the transparent entity, such as individuals and nongrantor trusts. As previously indicated, the tax rate on dividend income is increased to a maximum rate of 20%. In addition, dividends or inclusions of income under Subpart F or the P.F.I.C. rules will be subject to the new U.S. "net investment income tax."[7] The tax is imposed at the rate of 3.8% on the net investment income, or if lower, the excess of the individual's modified adjusted gross income[8] over a threshold amount varying from $125,000 to $200,000,

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[7] Code §1411.

[8] Modified adjusted gross income is the individual's adjusted gross income increased (if applicable) by the excess of the individual's foreign earned income over the deductions, exclusions or credits, including

depending on the individual's filing status. Net investment income consists of certain passive income reduced by allocable deductions. Passive income includes gross income from dividends. It also includes passive income in the form of interest, annuities, royalties, rents and other gross income if the gross income is derived either from a trade or business in which the U.S. individual does not materially participate or from a trade or business of trading in financial instruments or commodities. Net investment income also includes net gain attributable to the disposition of property held in one of those two types of trade or business activities. Proposed Regulations address the application of the 3.8% tax in the case of U.S. individual shareholders in C.F.C.s or Passive Foreign Investment Companies by providing that the tax may be imposed either at the time of the income inclusion or a subsequent time when cash is received.[9]

In the European context, many countries have tax laws that provide favorable income tax treatment for intercompany dividends paid across borders. Among these countries are Luxembourg, Denmark, Switzerland, England, Belgium, Spain, Cyprus, and the Netherlands. In Ireland, the tax rate is extremely low for trading profits of Irish corporations. Dividends received by Irish corporations out of earnings of foreign subsidiaries that arise from trading activities may be exempt from tax. The rules in place cause these jurisdictions to be popular locations for the formation of a holding company by a U.S. based group. Often, however, these countries have other provisions that may be considered less favorable to a holding company. Capital tax imposed on the issuance of shares and stamp tax on the transfer of shares are examples of unfavorable provisions. Other countries that have certain favorable features include Austria, France, and Germany, although none is typically thought of as a holding company location.

Recently, tax benefits claimed by holding companies in Europe have been challenged by the tax authorities in the European countries of residence of the paying companies. The challenges are directed at the substance of the holding company. Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management that is involved in day-to-day decision making. In some instances, the capital structure of the holding company is queried. These challenges suggest that it is prudent for a holding company to have more than tax residence in a particular country – it should conduct group functions in that country and be ready to provide evidence of the activities performed. These challenges suggest that the limitation on benefits articles of U.S. income tax treaties may provide benefits to taxpayers because of the objective standards that are included in the provisions and the attribution of active business activities of affiliates to related parties. In particular, the active trade or business provision of most limitation on benefits articles allows intermediary holding companies to be viewed as active participants in a business if they own at least 50% of a subsidiary or a partnership that has active business operations.

Substance is also a key concern in the report on base erosion and profit shifting ("B.E.P.S.") recently published by the Organization for Economic Cooperation and Development ("the O.E.C.D.").[10] The report was commissioned by the G20. It concludes that data in several

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foreign tax credits, allocable to the foreign earned income and not allowed as a deduction in calculating adjusted gross income. Code §1411(d).

9 Treas. Reg. §1.1411-10.

10 "Addressing Base Erosion and Profit Shifting", Organization for Economic Cooperation and Development, February 12, 2013.

studies indicate an increased disparity between (a) the location of actual business activities and investment and (b) the jurisdiction where the resulting profits are reported for tax purposes.

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

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

While the B.E.P.S. report has no legal authority, it indicates how the issue could be addressed in examinations by tax authorities in Europe and in upcoming legislation, and therefore constitutes a document to refer to before setting up a foreign holding company, with particular attention being given to the three tax planning structures identified in the report.[12]

The B.E.P.S. report illustrates a view that is now generally accepted by tax authorities on a global basis. Taxation should not be viewed as an expense. Rather it reflects a partnership profit sharing arrangement between governments and business. When schemes with no substance are followed to deprive the governments of their "profit share," business may conclude that proper tax planning practices have been followed for the benefit of their investors while governments may conclude that they are the victims of theft. The balance of this paper examines the tax treatment of holding companies in each of the foregoing jurisdictions. The goal is to determine whether the country provides tax treatment – alone or in conjunction with a second jurisdiction – that makes the formation of a holding company attractive to a U.S.-based group of companies.

2. LUXEMBOURG

Over the last decades, Luxembourg has been extremely popular as a holding and financing jurisdiction for E.U. or non-E.U. investors. Its position as an important financial center, the

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

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

professional environment it is able to offer, combined with advantageous tax treatment and corporate flexibilities give Luxembourg a leading role. More recently, Luxembourg has also adopted favorable measures to stimulate investments in intellectual property, family wealth investment platforms and to further enhance its position with respect to regulated and non-regulated investment funds.

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

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

Besides the S.O.P.A.R.F.I., Luxembourg law provides for two collective investment vehicles, both of which were introduced by new legislation in 2004.

On May 12, 2004, a regime was enacted for investments in risk-bearing capital (venture capital, private equity), namely the "*Société d'Investissements en Capital À Risque*" ("S.I.C.A.R."). Under certain circumstances, the S.I.C.A.R. can also be used as a tax efficient investment holding company.

The Law of March 22, 2004, introduced a legal and regulatory framework for securitization vehicles coupled with a favorable tax regime. The S.I.C.A.R. and the securitization vehicles will be dealt with in the final paragraphs of this chapter.

The investment fund platforms like the S.I.C.A.F., S.I.C.A.V., F.C.P. and the S.I.F. regime, are not discussed herein.

A. General/Participation Exemption

A S.O.P.A.R.F.I. established in the city of Luxembourg is subject to Luxembourg corporate income tax at a combined top rate of 29.22% since January 1, 2013 (national income tax, plus municipal business tax, plus a 7% surcharge for an unemployment fund).

Starting in 2011, a S.O.P.A.R.F.I. is subject to a fixed minimum amount of corporate income tax. Companies subject to this minimum tax they are defined as collective entities having their

statutory seat or their central administration in Luxembourg, and at least 90% of whose assets are financial assets. The minimum tax amounts to €3,210 (including the 5% surcharge). Losses carried forward remain in existence. If a S.O.P.A.R.F.I. is part of a Luxembourg fiscal unity, starting in 2013, subsidiaries as well as the parent company will be subject to the minimum tax. However, the maximum amount of minimum tax payable by a fiscal unity is set at €21,400 (including the 7% surcharge).

Beginning in 2013, the fixed minimum tax is considered an advance payment of corporate income tax due for future years. The condition is that the tax will only be considered as an advance payment if and as far as the taxpayer incurs corporation tax in future years. If no corporate income tax is incurred, the advance becomes a final tax payment. There is no limit to the time for minimum tax payments to be carried forward, and minimum tax payments made are not eligible for a refund.

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

i. Dividends

According to Article 166 of the Luxembourg Income Tax Act ("I.T.A."), dividends (including liquidation dividends) received by a S.O.P.A.R.F.I., are exempt from Luxembourg corporate 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 price of at least €1.2 million;
- The subsidiary is a collective entity or a company with a capital divided into shares and is (i) a resident of Luxembourg and fully subject to Luxembourg tax; or (ii) subject in its country of residence to an income tax that is comparable to the Luxembourg corporate income tax (see below); or (iii) is covered by Article 2 of the modified E.C. Parent/Subsidiary Directive (90/435/EEC), as amended from time to time (hereinafter: the "Parent/Subsidiary Directive"); and
- At the time of distribution, the S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, the participation for an uninterrupted period of at least 12 months; and during this period, its interest in the subsidiary may not drop below the threshold mentioned under (1) above (10% or acquisition value of €1.2 million).

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

ii. Capital Gains

According to the Grand-Ducal Decree of December 21, 2001, (as amended on March 31, 2004), on the application of Article 166 I.T.A., capital gains (including FX gains) realized by a S.O.P.A.R.F.I. upon the disposition of the shares of a subsidiary, are exempt from Luxembourg corporate income tax if the following requirements are met:

- The S.O.P.A.R.F.I. holds 10% or more of the issued capital of the subsidiary (which may be held via a tax transparent entity), or the participation has an acquisition price of at least €6 million;
- The subsidiary is (i) a resident of Luxembourg and fully subject to Luxembourg tax, or (ii) subject in its country of residence to an income tax that is comparable to the Luxembourg corporate income tax, or (iii) covered by Article 2 of the Parent/Subsidiary Directive; and
- The S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, a minimum participation as mentioned under (1) above for an uninterrupted period of at least 12 months.

B. Subject to Tax

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

The Luxembourg tax authorities take the position that a foreign corporate income tax is comparable if it is levied at a rate of at least 10.5% and the taxable profit is computed on a basis that is similar to that applied in Luxembourg. No list of countries whose corporate tax qualifies for these purposes exists. For subsidiaries established in treaty countries, the 10.5% requirement is generally fulfilled. In case of doubt, an advance ruling can be obtained from the Luxembourg tax administration.

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

C. Dividends or Capital Gains after Share Exchange

The Luxembourg I.T.A. provides for some tax-exempt exchange operations. A tax neutral exchange can under circumstances be allowed in case of:

- Conversions of a loan whereby securities representing share capital of the debtor are allocated to the creditor;

- Transformation of a capital company into another capital company;
- Mergers or divisions of capital companies or companies resident in an E.U. Member State; and
- Certain other mergers.

In order to benefit from the tax-exempt exchange operations, the book value of the transferred shares, or the book value of a loan in case of its conversion, must also be continued in the commercial accounts on the shares received in exchange.

After a non-qualifying participation has been transformed into a qualifying participation through such a tax neutral share exchange (*e.g.,* pursuant to a merger), the participation will continue to be deemed a non-qualifying participation for five fiscal years following the year in which the share exchange occurred (anti-abuse measure).

D. Luxembourg Permanent Establishment

The participation exemption also applies to dividends and gains on participations earned by, or attributed to, a Luxembourg permanent establishment of a nonresident taxpayer who is a resident of an E.U. Member State or a treaty country. If resident in a treaty country, it must be subject to tax (refer to Paragraph B of this chapter, above). It is not entirely clear what level of substance the Luxembourg authorities will require in order to allocate participations to such permanent establishment, but in a given situation, an advance tax clearance may be obtained on a case-by-case basis in order to ascertain the allocation.

i. Partial Participation Exemption

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

E. Withholding Tax in Foreign Subsidiary's Country

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

Luxembourg currently has income 64 tax treaties in effect (and more (45) under negotiation, out of which 9 are protocols or new treaties with existing partners) with the following countries:

Armenia
Austria
Azerbaijan
Bahrain
Barbados
Belgium
Brazil
Bulgaria
Canada
China (PRC)
Czech Republic
Denmark
Estonia
Finland
France
Germany
Georgia
Greece
Hong Kong
Hungary
Iceland
India
Indonesia
Ireland
Israel
Italy
Japan
Korea (ROK)
Latvia
Liechtenstein
Lithuania
Malaysia
Malta
Mauritius
Mexico
Moldova
Monaco
Mongolia
Morocco
The Netherlands
Norway
Panama
Poland
Portugal
Qatar
Romania
Russia
San Marino
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sweden
Switzerland
Thailand
Trinidad and Tobago
Tunisia
Turkey
United Arab Emirates
United Kingdom
United States
Uzbekistan
Vietnam

F. Deduction of Costs

i. Write-offs

The value of participation may be written down and a deduction may be claimed. If the participation is written down, a tax-deductible reserve may be created. These deductions could be used to offset other income (such as income from financing activities or commercial activities) and may result in tax losses. Losses may be carried forward indefinitely. However, the capital gains exemption does not apply to the extent of such previously deducted expenses and write-offs. As a result, if there is a capital gain arising from a subsequent disposition of the shares and not all of it is exempt, the non-exempt part may be offset with the loss reserves to the extent they are available to offset – and are absorbed by – exempt capital gain arising from a subsequent disposition of the shares (the recapture).

The same applies to the writing down of a receivable on the subsidiary, and to negative income from the subsidiary that has been deducted from taxable income derived from other sources.

ii. **Financial Costs**

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

Expenses are allocated on an historic direct-tracing basis, to the extent possible. Where direct tracing is not possible, expenses are allocated on a pro rata basis (*e.g.,* divided over the number or the value of the participations).

Currency gains and losses on loans to finance the acquisition of subsidiaries or operating loans are taxable or deductible, as the case may be. Therefore, currency exposure should be avoided, preferably by denominating such loans in Euro. Currency gains on the investment in the participation itself are exempt by virtue of the participation exemption. Currency losses on the investment itself are tax deductible, but may fall under the recapture rules.

iii. **Liquidation Losses**

A loss realized upon the liquidation of a subsidiary is deductible. Losses pertaining to a foreign permanent establishment of a Luxembourg resident company are, in principle, also deductible. Losses can be carried forward indefinitely.

G. **Withholding Tax on Outbound Dividends/Capital Gains**

i. **Dividend Payment**

Dividends distributed by a S.O.P.A.R.F.I. are subject to Luxembourg dividend withholding tax at the rate of 15%, unless an exemption or a lower treaty rate applies. (See also *infra* in respect of liquidation dividends.) Dividends paid by a Luxembourg company are exempt from Luxembourg dividend withholding tax if certain conditions are met and the dividend is paid to:

- E.U. resident parent collective entity eligible for benefits under the Parent/Subsidiary Directive;
- A non-exempt Swiss resident company;
- A Luxembourg or E.U. branch of an E.U. company;
- A Luxembourg branch of a company that is a resident of a treaty country and that meets the subject to tax test;
- A parent company that is considered as a tax resident in a treaty country and that is subject to tax comparable to the Luxembourg corporate income tax; or
- A company that is a resident of a European Economic Area country and that meets the subject to tax test (or a branch thereof).

The conditions that must be met are that (a) the dividend is paid in respect of shares forming part of at least a 10% interest in the subsidiary or of an interest with an acquisition price of at least € 1.2 million and (b) the shares have been held continuously for a period of at least twelve months immediately prior to the dividend payment, or the recipient commits itself to continue to hold those shares for at least twelve months.

The rate of dividend withholding tax takes into consideration the "beneficial" owner of the dividend, thereby disregarding certain tax transparent entities interposed between such "beneficial" owners and the Luxembourg company.

ii. Interest Payment on (Hybrid) Debt

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

In connection with the E.C. Savings Directive, Luxembourg introduced on July 1, 2005, a withholding tax, which currently is levied at a rate of 35% on interest paid through a Luxembourg paying agent (usually a bank) generally to E.U. resident individuals or so-called residual entities. For Luxembourg resident individuals, other rules apply.

Under certain conditions, hybrid debt instruments may be issued by a S.O.P.A.R.F.I. These hybrid debt instruments (*e.g.*, convertible preferred equity certificates commonly referred to as "CPECs") are normally treated as debt for Luxembourg legal, accounting and tax purposes but can be treated as equity for tax purposes in the country of the lender of the funds (*e.g.,* the U.S.). CPECs have quite a few equity characteristics. The expression "CPECs" is often used as a general term, but the precise terms and conditions may differ somewhat on a case-by-case basis.

H. Capital Gains in Hands of Shareholders

Resident individual shareholders (entrepreneurs whose business assets do not include shares) are taxable on the alienation of shares (including by way of liquidation) in a S.O.P.A.R.F.I. where:

- The alienation takes place within 6 months after acquisition (speculation gain); or
- The alienator holds, either directly or indirectly, a substantial interest in the S.O.P.A.R.F.I.

In very broad terms, a substantial interest exists if a shareholder either alone or together with certain close relatives has held a shareholding of more than 10% in a Luxembourg company at any time during the five-year period preceding the alienation. A gain realized on the alienation of convertible debt is subject to Luxembourg income tax if the holder has a substantial interest in the debtor.

Nonresident shareholders who do not have a Luxembourg permanent establishment to which the shares and/or the income/gains from the shares in a S.O.P.A.R.F.I. belong are only subject to

Luxembourg tax where they hold, either directly or indirectly, a substantial interest and (1) the alienation (including liquidation) takes place within 6 months after acquisition (speculation gain) or (2) in case of an alienation after 6 months, they have been a Luxembourg resident taxpayer for more than 15 years and have become a non-Luxembourg taxpayer less than 5 years before the alienation takes place. Note however, that Luxembourg, in general, will not be entitled to tax this gain under applicable tax treaties.

I. Liquidation of a S.O.P.A.R.F.I.

Under Luxembourg law, a full or partial liquidation distribution by an S.O.P.A.R.F.I. is considered to be a capital gain and therefore is not subject to dividend withholding tax. Such capital gain is, arguably, taxable pursuant to the above paragraph. However, Luxembourg, in general, will not be entitled to tax this gain under applicable tax treaties.

J. Repurchase of Shares in a S.O.P.A.R.F.I.

In principle, a repurchase of shares in a S.O.P.A.R.F.I. is subject to Luxembourg dividend tax insofar as there are retained earnings available in the S.O.P.A.R.F.I. However, a repurchase by the company and subsequent cancellation of all shares from one or a group of shareholders, who thereby cease to be shareholders, is considered to be a capital gain that is not subject to Luxembourg dividend tax (the so-called "partial liquidation"). For nonresidents, this entails that holders of a substantial interest are subject to Luxembourg capital gain tax based only on the aforementioned rules.

K. Other Tax Issues

i. Debt/Equity Ratio

There are no prescribed debt-equity ratios in Luxembourg law. Based on transfer pricing principles as generally applied by the Luxembourg tax authorities, one should generally avoid a debt/equity ratio in excess of 85:15 for the financing of subsidiaries. If a higher ratio is maintained, part of the interest payments may be considered a constructive dividend, which will result in such part not being deductible for Luxembourg corporate income tax purposes, and, depending on the case, Luxembourg dividend withholding tax becoming due. Interest-free debt, in general, qualifies as equity for purposes of the 85:15 test.

ii. Capital Duty

Luxembourg has no capital duty. Instead, a fixed registration duty of €75 is imposed for:

- Incorporation of Luxembourg entities;
- Amendment of the bylaws of Luxembourg entities; and
- The transfer of the statutory or actual seat to Luxembourg.

iii. <u>Annual Net Worth Tax</u>

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

A participation exemption is provided to the net worth tax: the exemption applies if the corporate tax participation exemption for dividend income is applicable, as previously discussed. No holding period is required for qualifying participations to be exempt from net worth tax.

The net worth tax is reduced by the corporate income tax, limited to the corporate income tax before other credits. The net worth tax may not, however, be credited against the minimum fixed corporate income tax described in Paragraph A. This limitation is subject to certain conditions, but if applicable, constitutes a considerable improvement compared to former regimes for the foreign parent company of a Luxembourg subsidiary that is tax resident in a country allowing a credit for foreign income taxes but not for foreign net worth taxes, such as the United States. Under prior law, Luxembourg corporate income tax was reduced by the credit for the net worth tax. When that occurs, a creditable amount of foreign taxes is technically reduced under Treas. Reg. §<u>1.901-2(e)(4)(i)</u>.

L. <u>S.I.C.A.R.</u>

Luxembourg law contains rules for a S.I.C.A.R., an investment company in risk capital, which introduces a new flexible and tax favorable vehicle for any investment in risk-bearing capital. The purpose of this law is to facilitate private equity and venture capital investments within the E.U.

The S.I.C.A.R. can be incorporated in the form of a capital company, such as an S.à r.l. or an S.A., or a transparent entity, such as an S.C.S. It is a regulated entity, though in a relatively light manner compared to investment funds, such as Undertakings for Collective Investments in Transferable Securities, ("U.C.I.T.S."). It is more heavily regulated than the S.I.F., which is a form of entity introduced in 2007. The S.I.C.A.R. is authorized by the *Commission de Surveillance de Secteur Financier* ("C.S.S.F."). At the same time, it benefits from flexible legal rules required for investment in private equity and venture capital.

The S.I.C.A.R. also benefits from a favorable tax treatment, similar to a S.O.P.A.R.F.I. In principle, a S.I.C.A.R. is fully taxable for corporate income tax purposes. However, income realized in connection with its investments in risk capital is fully exempt from corporate income tax. Other income, such as interest accrued on bank deposits, management fees, and the like, is normally taxed. Therefore, a S.I.C.A.R. is in principle entitled to the benefits of Luxembourg tax treaties and the Parent Subsidiary Directive. Furthermore, a S.I.C.A.R. is exempt from net worth tax and from withholding tax on dividend distributions it makes. Nonresident investors in a S.I.C.A.R. will not be subject to Luxembourg taxes on dividends distributed or capital gains realized on the disposal of the shares in a S.I.C.A.R.

M. Securitization Vehicle

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

The S.V. Law defines "securitization" very broadly as "the transaction by which a securitization vehicle acquires or assumes, directly or through another vehicle, the risks relating to claims, obligations, and other assets or to the activity of a third party by issuing securities the value or the yield on which depends such risks." Obviously, the purpose of such broad definition is to include within the securitization concept any existing or future stream of income or risk.

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 S.C., or in the form of a fund managed by a management company. Securitizations with Luxembourg S.P.V.'s outside the scope of the S.V. Law remain possible.

Only those securitization companies that continuously issue securities to the public are subject to prior approval and supervision by the Luxembourg's finance regulator, the C.S.S.F. In all other cases of single issuance of securities to the public or continuous private placements, no prior approval is required. Securitization funds are, as a general rule, subject to prior approval and supervision by the C.S.S.F.

The law offers flexibility and protection of investors' and creditors' rights and ensures bankruptcy remoteness of the securitization vehicle, by expressly confirming the effectiveness of "non-petition" and "non-attachment" clauses. In addition, the S.V. Law expressly allows 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.

The S.V. Law also introduces a new type of financial sector professional, the fiduciary representative ("*représentant-fiduciaire*"), which may be appointed to represent and manage the interests of investors and creditors of a securitization vehicle. A fiduciary representative must apply for a prior approval from the C.S.S.F.

A securitization vehicle can have one or more separate "compartments" that represent a distinct part of the assets, respectively a distinct joint ownership of fiduciary property. The compartments allow for the separation of management liabilities, recourse and liquidation.

The above-described flexible legal and regulatory aspects are coupled with an attractive tax regime. Securitization companies are in principle fully subject to Luxembourg corporate income tax at the standard combined rate of 29.22%. However, the securitization company may deduct from its taxable base all "commitments" owed to investors and creditors. These provisions should be interpreted so that all payments, either in the form of interest or dividend, made by the securitization company to its investors and creditors are tax deductible. The taxable result of the company could, therefore, virtually be reduced to nil. Securitization funds are considered as transparent for corporate income tax purposes.

Dividend distributions by a securitization company are not subject to withholding tax in Luxembourg as they are treated as "interest" for tax purposes. Therefore, a Luxembourg normally taxable parent company is not entitled to the participation exemption with respect to dividends and capital gains it realizes in connection to a participation in a securitization company.

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

Securitization vehicles are explicitly exempt from domestic annual net worth tax (0.5%).

3. DENMARK[13]

A. In General[14]

For years Denmark has been attractive to foreign investors for investment purposes for several commercial reasons such as:

- Highly developed infrastructure;
- High level of education combined with entitlement to terminate employment; and
- High coverage ratio of IT and electronic equipment.

The investor friendly environment is supported by a corporate tax regime primarily designed for operating entities and resulting in a regime that generally allows:

- Zero corporate tax on inbound dividends received by a Danish company with a participation of at least 10% in a subsidiary situated in the E.U. or in a country which has a double taxation treaty with Denmark or if the Danish company and the subsidiary are eligible for tax consolidation;

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[13] The author acknowledges the contribution of his colleague, Anne Becker-Christensen, in the preparation of this portion of the article.

[14] In June 2012, a bill was adopted by the Danish Parliament that restricted the use of loss carryforwards, increased penalties for transfer pricing noncompliance, required auditor certificates of compliance for transfer pricing documentation, and publicity of corporate tax matters. The bill is not discussed in this chapter.

- Zero withholding tax on outbound dividends to E.U./E.E.A. and treaty corporate parents having a participation of at least 10%; this exemption is subject to an anti-abuse rule. To prevent the use of Denmark as an intermediary to reduce withholding tax in other countries, an anti-avoidance rule has been enacted as of 2013. Denmark will no longer apply its internal exemption from withholding tax, and will apply a higher treaty rate, if (i) the outbound dividend distributed by the Danish company stems from dividends received from lower tier foreign affiliates; (ii) the shareholder of the Danish company is not entitled to the E.U. Parent Subsidiary Directive, and (iii) the Danish company is not the beneficial owner of the dividends it received (conduit situation) (see Paragraph I below); and

- Reduced tax on inbound and outbound dividends on portfolio shares (shareholdings of less than 10%) as a result of strong network of tax treaties with 74 countries.

The Danish corporate tax regime also provides for:

- No capital duty on capital contributions;

- No stamp or transfer duty (save in the form of registration charges) with respect to fixed property, ships and aircraft);

- No capital gains taxation on share profit at the level of Danish company, provided that the Danish company owns at least 10% of the shares in the subsidiary and no tax on capital gains from the disposition of a non-listed portfolio shares (holdings of less than 10%) Danish private limited company or a similar foreign company (see Paragraph F below);

- No wealth tax on foreign investors within holding period;

- No exit tax on foreign investors (foreign investors are not subject to limited Danish tax liability on their disposal of shares in a Danish company); and

- A flexible corporation law regime with no red tape.

On the other hand, some Danish rules have proven to discourage or hamper investments. These are:

- Danish controlled financial company rules under which investments in foreign finance companies do not benefit from the Danish Holding Regime;

- Corporate law restrictions on up-streaming of cash flow to foreign investors through loans from a Danish holding company or through the provision of security for the indebtedness of a foreign investor; and

- Tax legislation targeting debt leveraged acquisitions of Danish companies, in particular international tax planning strategies involving U.S.-Danish check-the-box structures and offshore financing structures.

B. Corporate Income Tax

A Danish company is subject to Danish income taxation at a flat rate of 25%. This rate applies whether or not profits are distributed.

A modified principle of worldwide income taxation applies. A Danish company is now generally taxed on the basis of a territorial principle in relation to profits from foreign real property and profits from a foreign permanent establishment ("P.E."). Similarly, losses from those items will not be deductible against taxable income in that Danish company. However, if an election has been made for cross-border tax consolidation (see Paragraph 3.K. below), profits and losses from foreign real property and from P.E. operations will be included in the Danish taxable income in accordance with the worldwide income principle. In addition, an anti-abuse rule provides that low-taxed financial income generated through a foreign branch is also included in the income of the Danish company.

Danish domestic tax law may be modified under a relevant double taxation treaty. No local income taxes are levied by cities or regions on companies or branches in Denmark.

C. Withholding Tax in Foreign Subsidiary's Country

Dividends paid by a foreign subsidiary to a Danish holding company may be subject to withholding tax, which may be eliminated or reduced pursuant to the E.U. Parent Subsidiary Directive or a tax treaty concluded by Denmark and foreign subsidiary country.

Denmark currently has income tax treaties in effect with the following countries:

Argentina
Armenia
Australia
Austria
Bangladesh
Belarus
Belgium
Brazil
Bulgaria
Canada
Chile
Croatia
Cyprus
Czech Republic
China
Egypt
Estonia
India
Indonesia
Ireland
Israel
Italy
Jamaica
Japan
Kenya
Kyrgyzstan
Latvia
Lithuania
Luxembourg
Macedonia
Malaysia
Malta
Mexico
Montenegro
Romania
Russia
Serbia
Singapore
Slovakia
Slovenia
South Africa
Sri Lanka
South Korea
Sweden
Switzerland
Tanzania
Thailand
Trinidad and Tobago
Tunisia
Uganda
Ukraine

The Faeroe Islands
Finland
Georgia
Germany
Greece
Greenland
Hungary
Iceland
Morocco
Netherlands
New Zealand
Norway
Pakistan
The Philippines
Poland
Portugal
United Kingdom
Turkey
United States
Venezuela
Vietnam
Yugoslavia
Zambia

Limited tax information exchange agreements ("T.I.E.A."s) have been concluded with a number of other countries.

D. Corporate Taxation of Inbound Dividends

Dividends received from a foreign subsidiary are generally exempt from Danish corporate income tax if the following conditions are met:

- The foreign subsidiary qualifies as a "company" under Danish law; and
- Either (i) The Danish company holds at least 10% of the shares of the foreign subsidiary, and foreign subsidiary is covered by the E.U. Parent/Subsidiary Directive or is resident in a state that has concluded a double taxation treaty with Denmark according to which the withholding taxation of the dividends is reduced or waived or (ii) The Danish company and the foreign subsidiary qualify for international joint taxation (generally meaning that the Danish company must control more than 50% of the votes in the foreign subsidiary); and
- And the dividend is not received from a non-E.U. entity, which has taken a tax deduction in respect of the dividend payment.

If the Danish company holds less than 10% of the foreign subsidiary, the dividend payment will be subject to tax at the standard corporate income tax rate of 25%.

The qualification of a foreign subsidiary as a "company" is made by applying Danish law. No regard is given to the classification of the entity under foreign law. The issue is a question of fact and the criteria applied include whether, by the terms of local law or an entity's corporate charter: (i) the entity carries on business for profit, (ii) the entity has a fixed share capital, (iii) the entity provides limited liability for all its shareholders, and (iv) the claim on the profit of the entity is apportioned to the owners by reference to their respective share holdings. In addition, an entity that is formed under the laws of a member of the E.U. is treated as a corporation if it is subject to the Parent/Subsidiary Directive. If for some reason, the directive is inapplicable, the entity will be characterized under the four-pronged standard that generally applies.

E. C.F.C. Taxation

i. C.F.C.

Danish tax law contains controlled financial company ("C.F.C.") provisions, which apply to financial subsidiaries in all jurisdictions including Denmark, with no regard to the subsidiary's tax burden.

If applicable, the C.F.C. regime provides that a Danish shareholder of the C.F.C. must include the total taxable income of the C.F.C. The Danish shareholder may however offset any taxes paid by the subsidiary. If the shareholder does not own the entire share capital of the C.F.C., the Danish shareholder will include only his pro rata share of C.F.C.s income.

In general, the C.F.C. regime applies if the following three conditions are met:

- The Danish company and the foreign subsidiary are group-related (see Paragraph L below). Generally, group-relation exists if the Danish company directly or indirectly holds more than 50% of the foreign subsidiary's voting rights;
- The C.F.C. income comprise more than half of the aggregate taxable income of the foreign subsidiary; and
- The subsidiary's financial assets represent more than 10% of its total assets.

C.F.C. income is conclusively defined in the law and includes:

- Net interest income;
- Net gains on receivables, debts and financial instruments;
- Certain commissions;
- Dividends;
- Net capital gains on shares, but only to the extent they are taxable under Danish law. Consequently, dividends and capital gains that benefit from the Danish participation exemption are not considered to be tainted income;
- Royalty payments and capital gains arising from intellectual property rights, unless the intellectual property arose from the subsidiary's own research and development activities and the payments in issue are made by an unrelated party;
- Deductions claimed for tax purposes by a Danish company that relate to the income items listed above;
- Leasing income deriving from financial leases including losses and gains on the assets involved; and

- Insurance, banking and other financial activities, unless an exemption is otherwise applied for.

The assessment is made on the basis of the facts that occur during the year. Losses from previous years that are eligible to be carried forward and group contributions are not taken into account when computing the foreign subsidiary's total income or its C.F.C. income.

If the C.F.C. is, itself, the shareholder of other, lower-tier subsidiaries in the same jurisdiction, all computations are made on a consolidated basis. As a result, dividends from other, lower-tier subsidiaries and capital gains realized from the disposition of the shares of those subsidiaries are disregarded when computing the income threshold.

When making an assessment of whether the subsidiary's financial assets represent more than 10% of its total assets, the following financial assets are not included:

- The financial assets on which the yield/gains are tax exempt, such as Subsidiary Investments where the subsidiary owns at least 10% of the share capital, and the subsidiary is not considered as a trader in securities; and

- The shares in lower-tier subsidiaries, which are controlled by the subsidiary and located in the same jurisdiction as the subsidiary. Instead, the financial assets in the lower-tier subsidiaries are included proportionately in accordance with the subsidiary's direct or indirect ownership share.

F. Capital Gains Taxation

Danish resident companies are exempt from tax on gains realized on shareholdings of 10% or more. With effect from January 1, 2013, capital gains realized by a Danish resident company on shareholdings below 10% in a non-listed company are generally also tax exempt.

However, these rules do not apply if the Danish company is a trader in securities and the shares are acquired for trading purposes. A trader in securities is defined as a person that is engaged in the business of selling and buying securities on a systematic, professional and extensive basis. Any such gains or losses are included in taxable income for a trader. Shares are considered bought for trading purposes if the shares have been bought by the trader in the course of the traders business with the purpose of selling the shares again for a profit.

Share gains derived by a Danish company which do not qualify for tax exemption, are subject to tax at the standard corporate income tax rate of 25%.

A non-resident company is a point of departure exempt from Danish tax on gains realized on shares in a Danish company. However, a new anti-avoidance rule has been introduced which entails that payment received, or deemed to be received, by a foreign entity in connection with an intra-group transfer of Danish shares will be recharacterized as a taxable dividend payment if:

- The foreign entity transfers shares held in a group related Danish entity to another group related entity for consideration consisting of other valuables than shares in the receiving group entity; and

- The transferring foreign entity would not have qualified for exemption from Danish withholding tax on dividends received from the transferred Danish entity prior to the transfer.

Payment received, or deemed to be received, by a foreign entity as consideration for Danish shares will if the above criteria are met, be subject to Danish dividend withholding tax of 27%, subject however to reduction by treaty.

G. Interest Deductibility Limitations

Interest expense incurred by corporations is generally deductible in computing taxable income if the debt involves a binding legal commitment. Interest paid to related parties must be calculated on an arm's length basis. Interest expense incurred on certain debts owed to the government is not tax deductible. An example of nondeductible interest is the interest that accrues on unpaid tax.

i. Thin Capitalization

Denmark has enacted thin capitalization rules regarding intercompany debt, which may limit the deductibility of interest on debt owed to group-related entities ("Controlled Debt"). These thin capitalization restrictions apply only to the extent the Danish company has Controlled Debt exceeding a *de minimis* threshold of DKK 10 million (approximately € 1,341,000 million). Further, the thin capitalization rules only apply to the extent the debt to equity ratio exceeds 4:1. In such case, the limitation of interest deduction applies to that portion of the Controlled Debt that exceeds the 4:1 threshold. Taxpayers having such excess debt are typically advised to convert the excess into equity in order to avoid the limitation of deductibility.

For the purpose of the thin capitalization rules, Controlled Debt means debt owed by a Danish debtor company (the "Danish Debtor") to a Danish or foreign related legal entity. A related legal entity is a legal entity which:

- Is controlled by the Danish Debtor; or
- Controls the Danish Debtor; or
- Is group-related with the Danish Debtor.

Control means that more than 50% of the shares or voting rights are owned or controlled, directly or indirectly. When determining whether the lender *controls* the Danish Debtor (or *vice versa*), votes and shares held by all group-related entities are taken into account. Votes and shares held by unrelated shareholders may also be taken into account if an agreement has been made between the lender and the unrelated shareholders for the purpose of "*exercising a common controlling influence*" over the Danish Debtor.

Group-related entities mean two or more entities that are (i) directly or indirectly controlled by the same group of shareholders or (ii) under common management. The lender and the Danish Debtor may be considered to be *group-related* by virtue of common management if they have the same manager or if they have different managers that have entered into an agreement providing for a common management of the lender and the debtor.

Not only taxable legal entities are considered under the above definitions. Fiscally transparent entities may be considered if they are "are governed by rules of corporate law, a corporate law agreement or articles of association." Such entities may, for these purposes, be treated as entities that have separate legal personality and identity for tax purposes.

Finally, Controlled Debt means debt to an unrelated entity, when a related entity has provided credit support. A back-to-back loan is regarded as credit support.

ii. Additional Limitations

The Danish corporate tax regime includes two additional limitations on the deductibility of financial expenses which apply in respect of controlled debt as well as third party debt.

As a result, the deductibility of interest expenses and other financial expenses incurred by Danish companies are subject to the following three limitations (in chronological order):

- A limitation based on debt/equity ratio (the thin capitalization rules, *see* Paragraph G.i, of this chapter, above);

- A limitation based on the tax value of assets ("Asset Limitation Rule") entailing that net financing expenses exceeding DKK 21.3 million (approximately €2.762 million, (2012 figure)) are deductible up to a cap equal to the combined value of (i) 3.5% (2012 figure) of the tax base of Danish operating assets and (ii) 12.5% (2012 figure) of the value of foreign subsidiaries; and

- A limitation based on annual profits ("E.B.I.T. Limitation Rule") entailing a maximum interest deduction of 80% of E.B.I.T. The limitation only applies if the net financing expenses exceed DKK 21.3 million (approximately €2.762 million as of 2012).

iii. Calculation of Net Financial Expense

For the purpose of the Asset Limitation Rule and the E.B.I.T. Limitation Rule, net financial expenses are calculated as the sum of:

- Taxable interest income and deductible interest expenses (excluding interest income/expenses from trade debtors and creditors);

- Loan commission fees and similar expenses;

- Taxable capital gains and losses on claims, debts, bonds, financial instruments (excluding gains/losses on claims acquired in trade if the contracting party is a related party);

- Gains/losses on forward contracts relating to the hedging of operating income (provided that the forward contracts are not acquired in trade);

- Deemed finance charges relating to financial leasing arrangements (defined in accordance with I.A.S. 17);

- Taxable capital gains and deductible capital losses; and

- Taxable dividends.

Interest expenses and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses. The calculation of net financial expenses is made on a group basis for Danish companies, which are subject to Danish tax consolidation. If the Danish company/group has net financial expenses exceeding the DKK 21.3 million threshold, such net financial expenses will subject to restrictions under the Asset Limitation Rule and the E.B.I.T. Limitation Rule as discussed below.

iv. Restrictions under the Asset Limitation Rule

Net financial expenses in excess of DKK 21.3 million will only be deductible by an amount corresponding to 3.5% of the tax value of certain assets.

For the purpose of computing the 3.5% ceiling, only certain qualifying assets are considered, including inter alia:

- The tax book value of depreciable assets;
- The acquisition price on non-depreciable assets;
- Carry forward tax losses;
- The net value of work-in-progress and account receivables.

Shares are not considered as qualifying assets except as for shares in directly owned foreign subsidiaries which may be included up to 12.5% (2012 figure) of the acquisition price (subject to certain price adjustments). The in part inclusion the directly owned foreign subsidiaries are being phased out by 2.5% each year starting with a qualifying inclusion ratio of 17.5% in 2010 and ending with 0% in 2017.

Claims, notes and financial instruments are not considered as qualifying assets either. This means that the value of the FX notes to be purchased by Danish Newco will not be included in the computation of the 3.5% ceiling. For companies that are subject to Danish tax consolidation, the computation of the 3.5% ceiling will be made on a consolidated basis.

Net financing expenses that are restricted under the Asset Limitation Rule will generally be lost in that they cannot be carried forward. However, restricted losses on claims, notes and financial instruments may be carried forward and set off against future capital gains of a similar nature realized within the following three accounting periods.

In addition to the limitations triggered by the thin capitalization rules and the Asset Limitation Rule, a company's or group's net financial expenses must not exceed more than 80% of E.B.I.T. ("Earnings Before Interest and Tax").

Net financing expenses below DKK 21.3 million will never be restricted under the E.B.I.T. Limitation Rule (but may be restricted under the thin capitalization rules which, however, only apply on controlled debt). The DKK 21.3 million ceiling (which is adjusted annually) is calculated on a group basis for Danish companies that are subject to Danish tax consolidation.

In comparison to the Asset Limitation Rule, net financial expenses that are restricted by the E.B.I.T. Limitation Rule may be carried forward.

H. Withholding Tax on Outbound Dividends

Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for an elimination or reduction of the Danish withholding tax by virtue of the E.U. Parent/Subsidiary Directive (as amended by Council Directive 2003/123/EC) or a tax treaty between Denmark and the parent company's state of residence. If these conditions are not met, a 27% withholding tax is levied, subject, however, to subsequent refund if a lower rate is provided by treaty.

I. Tightening of the Danish Rules for Exemption of Danish Dividend Withholding Tax

In recent years, the Danish tax authorities have sought to narrow the scope of the withholding tax exemption by limiting the benefit to corporate shareholders that qualify as "beneficial owners" of dividends. Now, the Danish Parliament has introduced an anti-avoidance provision under which the dividend withholding tax exemption will not apply where the Danish company acts as a conduit from one foreign corporation to another. The provision is applicable when the dividend distributed by a Danish company to its foreign corporate shareholder constitutes an "on-payment" of dividends received from a foreign subsidiary. In that set of circumstances, the Danish company does not qualify as the beneficial owner of the dividend from the foreign subsidiary and the dividend paid to the foreign shareholder will not be exempted from tax but will be subject to tax at the applicable treaty rate.

The legislative notes to the provision explain that the definition of the beneficial owner used in the O.E.C.D. model income tax convention will apply in determining whether the Danish company is the beneficial owner or merely a conduit. It can be inferred from the legislative notes that a Danish holding company will generally not qualify as the beneficial owner of dividends received.

The provision is not applicable if the corporate shareholder of the Danish company is entitled to the benefits of the E.U. Parent-Subsidiary Directive. The new provision will therefore only affect corporate shareholders resident in jurisdictions which have a tax treaty with Denmark, such as the U.S.

J. Interest Withholding Tax and Check-the-Box Countermeasures

As a starting point, a 25% withholding tax applies to interest payments made by a Danish company to a foreign related entity. (See definition of related legal entity above in Paragraph E.i of this chapter.) However, a foreign related lender will be exempt from Danish interest withholding tax if it falls into one of the following categories:

- The foreign related lender has a permanent establishment in Denmark to which such interest income is attributed; or
- The foreign related lender is protected under the Interest/Royalty Directive (2003/49/E.U.) (no tax is levied and no withholding tax applies); or
- The foreign related lender is protected under a tax treaty with Denmark (irrespective of treaty rate); or
- The foreign related lender is controlled (as defined under Danish C.F.C. rules) by a Danish entity; or
- The foreign related lender is controlled by a party resident in a country that has concluded a tax treaty with Denmark, and further that such country may tax the lender on such interest payments pursuant to C.F.C. taxation rules of that country; or
- The foreign controlling or group related lender can demonstrate that it has paid foreign income tax on the interest received at a rate of at least 18.75% equivalent to ¾ of the normal Danish flat corporate tax rate and further provided that it has not entered into a back-to-back loan with an entity that that has paid foreign income tax on the interest received at a rate of less than 18.75%.

The interest withholding tax rule is part of a dual regime that aims at curbing international tax planning based on leveraged structures where the foreign lender is not taxed on the interest income received from a Danish company. Together with the interest withholding tax rule, a special rule (Section 2A of the Corporation Tax Act) limits the deductibility of certain cross border payments made to foreign group-related entities resident in an E.U./E.E.A. or treaty state. The primary aim of Section 2A is to counteract certain U.S. - Danish check-the-box structures.

The mechanisms of Section 2A can be summarized as follows. A Danish company or a foreign company with a permanent establishment in Denmark would be deemed transparent for Danish tax purposes if:

- The Danish company according to the rules of a foreign state is treated as a fiscally transparent entity, whereby the income of the company is included in the taxable income of a controlling foreign legal entity, *i.e.*, an entity that owns directly or indirectly more than 50% of the Danish company or holds more than 50% of the voting rights (see the definition of control in Paragraph 3.g) and

- The foreign state in question is an E.U./E.E.A. member state or has a tax treaty with Denmark

If these conditions are met, the Danish company would, for Danish tax purposes, be classified as a transparent entity, and consequently, be treated as a branch of the controlling foreign entity. Being treated as a branch, the Danish company would not be entitled to take a deduction for payments made to the foreign parent company or to other group-related entities, which are treated as fiscally transparent by the foreign parent company. (See modification immediately below.) The payments would be considered to be within the same legal entity. This also means, however, that irrespective of the general requirements, dividend payments made to the foreign parent company would not be subject to any Danish withholding tax.

As an exception to the general rule outlined above, payments made by a Section 2A company to other group-related entities that are treated as fiscally transparent by the foreign parent company remain tax deductible if the receiving group-related entity is a tax resident of an E.U./E.E.A. or treaty state, and that state is different from the state where the parent company is resident. It should be noted that Section 2A only applies when the Danish company and all intermediate holding companies above the Danish company are treated as fiscally transparent by the foreign parent company. The rule would not apply if the Danish company were owned by the foreign parent company through an entity resident in a third state and the income of that entity was not included in the taxable income of the foreign parent company.

Further, it should be noted that certain tax consolidation rules such as the U.S .tax consolidation rules may be considered to have the same effect as fiscally transparency and therefore may trigger Section 2A status. The key scenario is a U.S. company that has a branch in Denmark. The U.S company/head office may be deemed transparent under Section 2A if the head office is tax consolidated with a U.S. parent company. In such event, payments made by the Danish branch to the U.S. parent company would be considered to be within the same legal entity and thus not deductible.

A Danish company, which has been classified as a transparent entity under Section 2A, will not be considered a Danish tax resident and thus, will not be entitled to the benefits of E.U. directives and tax treaties concluded by Denmark.

K. <u>Transfer Pricing</u>

Under Danish law, transactions between related parties must be carried out in accordance with the arm’s length principle. The arm’s length principle is defined in accordance with O.E.C.D. guidelines and the Danish tax authorities recognize the methods set out in the guidelines.

When filing its tax returns, a Danish company must report the type and scope of transactions with related legal entities. In addition, a Danish company is required to prepare and keep

documentation on the methods used in determining the prices and terms of the transactions with related parties. Documentation may be prepared in Danish, Swedish, Norwegian or the English language.

Small and medium sized companies are relieved of the obligation to prepare documentation. These businesses are only required to prepare documentation for transactions with related companies resident outside the E.U. and only if Denmark does not have a double tax treaty with the country in question. Small and medium sized companies include companies which, on a consolidated basis, have (i) less than 250 full time employees during a year and (ii) either assets below DKK 125 million (approximately €16,757,000 million) or turnover below DKK 250 million (approximately €33,515,000 million).

In 2012 the general penalty rules on insufficient transfer pricing documentation were tightened. The penalty for noncompliance is calculated on 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.

The Danish tax authorities are now allowed to request a special auditor's statement concerning the transfer pricing documentation. It is a condition for the tax authorities' request that the company has controlled transactions with low-tax countries or the company's annual reports have shown average operating losses for the previous four years measured at the E.B.I.T. level.

L. Group of Companies – Joint Cross Border Taxation

Under the Danish tax consolidation regime, Danish companies and Danish branches of foreign companies, which are group-related as defined, are subject to mandatory Danish tax consolidation. Foreign branches of Danish companies in the group are not included unless an election for cross-border tax consolidation has been made. With respect to cross-border tax consolidation, the all-or-none principle applies. While tax consolidation with foreign group companies is voluntary, the all-or-none principle means that either (i) all group entities (Danish and foreign) are included in the tax consolidation scheme or (ii) none of them is included. The decision to form a cross border tax consolidation group is binding for a period of 10 years. In the event the consolidation is terminated within the 10-year period, foreign tax losses that were deducted are fully recaptured.

The regime applies to all related companies meeting the definition of group-related companies set out in the Danish Financial Statements Act. Consequently, a qualifying group-relation exists if a company, foundation, association, trust, or other entity:

- Has the majority of the voting rights in another company; or
- Is a shareholder and has the right to appoint or dismiss a majority of the members of another company's management; or

- Is a shareholder and is entitled to exercise control over another company's operational and financial management on the basis of the articles of association or agreement with that other company; or

- Is a shareholder and controls the majority of the voting rights in another company on basis of a shareholder's agreement; or

- Is a shareholder in another company and exercises control over that company's operational and financial management.

The basic principles for determining and calculating consolidated income tax have not changed. The administration company and the entities of the tax consolidation where all the shares directly or indirectly are owned by the ultimate parent at the end of the income year are jointly and severally liable with the parent company for the tax charges plus the surcharges and interest allocated to the company in that income year.

The taxable income of the consolidated group is computed company by company. The consolidated income is created by netting out the taxable results, so that losses in one company offset profits in another. Losses incurred by a group company before entering into the tax consolidation scheme cannot be set off against the taxable profits of other group companies, but only against its own future profits. Tax consolidation does not eliminate capital gains that arise from the transfer of fixed assets between group companies and there are no other special provisions exempting such gains from corporate income tax.

As from income year 2013, the ability to claim a benefit from a loss carryforward is limited. A loss of DKK 7.5 million (as adjusted annually) can be offset against positive income in the carryover year. The remaining loss can reduce up to 60% of the remaining income. Any remaining loss can be carried forward indefinitely. Net operating loss carrybacks are not allowed.

Special transition rules apply with regard to the recapture of foreign tax losses upon the termination of a tax consolidation scheme established under the old regime.

M. Interim Dividends

Danish corporate law allows for distribution of interim dividends. Interim dividends may be distributed several times a year; however, interim dividends can only be distributed after the publication of the company's first financial year. Interim dividends may be distributed out of the free reserves and the profits realized in the current year as of the date of the interim balance sheet. While ordinary annual dividends are distributed only upon the decision of the general shareholders' meeting, the decision to distribute interim dividends can also be made by the board of directors pursuant to an authorization given by the shareholders. The authorization does not have to be stipulated in the company's articles of association, however, many shareholders chooses to include such authorization provision in the articles of association to evidence that an authorization has been issued.

N. Binding Advance Ruling

Binding rulings, including advance rulings, on specific proposed transactions can be obtained from the Danish Tax Authority. A fee (currently a minimum of €40) is charged for binding rulings. Persons not subject to Danish tax liability are also entitled to ask for binding rulings. Binding rulings are generally issued within one month, but might be issued much later for complex issues. Binding rulings can be appealed to the National Tax Tribunal and to the City Courts and the High Courts.

The binding ruling will be binding for the tax authorities for a period of five years. However, it is possible for the tax authorities to shorten the period if required by the circumstances.

4. SWITZERLAND

A. In General

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

The general federal corporate income tax for ordinary taxed companies is 8.5%, computed before tax expense, and approximately 7.8%, computed on an after tax basis. The cantonal/communal corporate income taxes depend on the company's location: the rates after deduction of taxes vary between 12.2% in Lucerne, to 12.51% in Zug, to 12.66% in Appenzell Ausserrhoden, Obwalden and Nidwalden, to 21.15% in Zurich and 24.17% in Geneva (incl. federal, cantonal and communal corporate income taxes).

In addition to the corporate income tax, corporate wealth taxes must be considered. On the cantonal/communal level, holding companies have to pay a wealth tax in the range of 0.001% to 0.075%, *i.e.*, CHF 10 up to CHF 750 per CHF 1 million taxable capital. The respective tax rates have been reduced dramatically in recent years, and in some cantons, there exists the possibility to credit corporate income taxes against the corporate wealth tax. There is no federal corporate wealth tax.

B. Taxation of Holding Companies [15]

i. Corporate Income Tax

If a company qualifies as a holding company for tax purposes, it will be fully exempt from cantonal/communal corporate income taxes. The main purpose of the holding company as per the bylaws must be the holding and management of long-term financial investments in affiliated companies. Furthermore, to qualify as a holding company, one of two tests has to be met. Either

[15] Discussions are under way regarding the cantonal tax regimes such as holding, mixed and domicile companies in the framework of the third round of the Swiss corporate tax reform. For possible consequences see C. v.

two-thirds of the company's total income must be derived from qualifying participations[16] or two-thirds of the assets reported on the company's balance sheet must be qualifying participations (at book values, or, if the test can be fulfilled at fair market values, at those higher values).

On the federal level, the general income tax is 8.5% (before taxes) and, generally speaking, only income other than dividend income from qualifying participations will be taxable. In other words, the participation exemption which reduces the taxation of dividends income to almost zero applies to dividends from qualified participation, meaning a participation of at least 20% of the capital right in another company or participation with a fair market value of at least CHF 2 million. To further mitigate the double taxation burden on the business profit, participations of at least 10% or with a fair market value of at least CHF 1 million will qualify as qualifying participations as of January 1, 2011. However, the tax on dividends can be somewhat higher than zero if the participations have been financed with loans by the holding company and the holding company receives interest payments from its participation. The effective corporate income tax rate on dividend income is in many cases virtually nil and almost never greater than 2%.

ii. Corporate Wealth Tax[17]

As already described, there is no federal corporate wealth tax. In most cantons holding companies have to pay a substantially reduced corporate wealth tax, *i.e.*, in the canton of Obwalden the wealth tax for holding companies amounts up to only 0.001% of the company's total wealth (at book values), *i.e.*, CHF 10 per CHF 1 million capital, with a minimum capital tax of CHF 500 per annum. Most of the other cantons have also reduced their corporate wealth tax or intend to do so in the near future.

As of January 1, 2009, the cantons may credit corporate income taxes against wealth tax. Some cantons introduced this new system already. However, no credit will be granted if no income tax is due.

iii. Stamp Duty at Formation[18]

An incorporation which entails a cash contribution to a Swiss company (company limited by shares, "*Aktiengesellschaft*") or a limited liability company ("GmbH") is subject to a 1% stamp duty on the amount of share capital or equity contributed. The first CHF 1 million of share capital are tax free.

However, Swiss holding companies are frequently incorporated by way of reorganization, which is free of the 1% stamp duty. To qualify as a reorganization for stamp duty purposes certain

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[16] A qualifying participation is either at least 10% of the capital rights in another company or the fair market value of such participation is at least CHF 1 million.

[17] Also in the scope of corporate wealth tax, discussions are going on within the Swiss corporate tax reform. For possible consequences see C. v.

[18] Regarding stamp duty it also has to be mentioned that discussions are going on within the Swiss corporate tax reform. For possible consequences see C. v.

conditions must be met. First, at least one 50% participation has to be contributed in the form of a quasi-merger. Second, the nominal share capital of the new holding company must not exceed the total nominal share capital of the contributed companies. If the contributed companies have low nominal share capitals (*e.g.*, U.S. or U.K. companies having shares with no or only a very low nominal value), the Swiss debt/equity rules (as described below in Paragraph 4.C.iii of this chapter) apply vice versa, *i.e.*, for Swiss stamp duty purposes a "normal" share capital will be calculated and applied as the contributed nominal capital of such company. Normally 30% of the fair market value of the contributed company can be reflected as nominal share capital in the acquiring company.

iv. Stamp Duty upon Capital Contributions

In addition to the above described stamp duty at formation, a Swiss company is also subject to stamp duty of 1%, if shareholders contribute funds, after incorporation, not only into the nominal share capital but directly into the company's reserves. Such contributions may occur in form of cash infusions, contributions in kind at a value lower than fair market value or waivers of shareholder's loans, etc.

For distressed Swiss companies, there is now a remarkable exception to the above mentioned rule: every Swiss company has, in its lifetime, a CHF 10 million stamp duty exemption in the context of a reorganization.

v. Capital Gains Tax

Capital gains realized by a corporation, whether or not it is a holding company, might be subject to the participation exemption on the federal level. To qualify for the exemption, the selling corporation must dispose of at least a 20% participation and the participation must have been held for at least one year. In contrast to the dividend exemption, the alternative market value test of CHF 1 million is not applicable. If less than 10% of the participation is sold, the gain is subject to the participation reduction, provided the value of the participation in the latter case had a fair market value of at least CHF 1 million at the end of the tax period prior to the sale. In both cases a holding period of at least one year is necessary. Furthermore, holding companies continue to be exempt from cantonal and communal taxes on capital gains.

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

A Swiss holding company might be subject to V.A.T. at the present rate of 7.6% if it provides services and receives management fees from affiliates or other service income in excess of CHF 100,000 per year. On the other hand, in these cases the input V.A.T. could be recovered partially or completely.

Every holding company can register as a V.A.T. payer if certain conditions are met. This would entitle such holding companies to a full (or at least reduced) refund of any input V.A.T. (*e.g.*, on advisor's or auditor's fees etc.).

vii. Securities Turnover Tax

Swiss companies holding securities with a book value of at least CHF 10 million will be categorized as a securities dealer for securities turnover tax purposes. Once categorized (which

normally is the case six months after the first financial statement shows securities of at least CHF 10 million), the acquisition and disposition of securities will be taxable at a total rate of 0.15% for Swiss securities and 0.30% for foreign securities (normally born each 50% by seller and acquirer).

viii. Swiss Withholding Tax[19]

Dividend distributions by Swiss companies are generally subject to a 35% Swiss withholding tax. However, dividend payments from Swiss companies to other Swiss companies can be carried out in a declaration procedure without cash payments of tax, if the Swiss beneficiary company owns at least 20% in its Swiss subsidiary.

For dividends paid to any E.U. parent company controlling at least 20% in the Swiss subsidiary (or such lower percentage provided in an applicable treaty), the refund system for withholding tax has been abolished and replaced by a general exemption system. Before paying a dividend without deduction of the full 35% Swiss withholding tax, the Swiss subsidiary must file a special request with the Swiss federal tax administration and must receive a permit to pay at the reduced treaty rate.

If the parent is based in the U.S. and certain other countries, dividend payments are subject to a withholding tax of only 5%. To obtain this beneficial rate, the shareholding in the Swiss company must be at least 10% of all voting rights and an advance agreement must be obtained from the Swiss tax authorities. The refund system is inapplicable.

Moreover, after the Bilateral Agreements II with the E.U. entered into force on July 1, 2005, all withholding tax rates in parent-subsidiary relationships (at least 25 % participations and a holding period of at least two years) have been reduced down to 0%. Therefore, the respective dividends from Swiss subsidiaries to their E.U. parent companies can be paid without any Swiss withholding tax, if the respective permit has been received from the Swiss Federal Tax Administration before the Dividend is paid out by the Swiss company.

As of January 1, 2011, Switzerland has introduced a new concept with regard to equity in Swiss companies not being subject to Swiss withholding tax upon repatriation to the shareholders on an ongoing basis as dividends or upon liquidation of a company in form of a liquidation surplus.

Until the end of 2010, Swiss withholding tax law followed the so called "nominal value principle," under which only the repayment of the nominal share capital of a Swiss company was exempt from Swiss withholding tax. This long-criticized law has been modified so that each Swiss company is required to show all equity contributions since January 1, 1997 in its financial statement in the first financial statement ending after December 31, 2010.

Examples for so qualifying "new" equity are shareholder's contributions to a Swiss company's capital surplus and other contributions which were subject to the Swiss stamp duty. Every Swiss

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[19] Regarding Swiss withholding tax it is important to refer to the on-going discussions within the Swiss corporate tax reform. For possible consequences see C. v.

company therefore was required to analyze all balance sheets and activities since January 1, 1997, in order to fulfill the required bookkeeping adjustments.

The value of such "new" capital is equal to the reduction of withholding tax, viz., 35% (or a lower treaty rate) of the capital that would be subject at the Swiss withholding tax under the old law.

ix. Tax Credit for Foreign Withholding Taxes

For non-refundable foreign withholding taxes, Switzerland provides a limited tax credit ("*pauschale Steueranrechnung*"). However, since Swiss holding companies are only subject to the federal income tax, only one-third, at most, of the foreign tax can be credited. Moreover, the tax credit is limited to the federal tax payable in a certain tax period, unless steps are taken in advance to counteract this limitation.

x. Swiss Tax Treaty Network

Switzerland has income tax treaties with more than 120 countries, including all old and new E.U. countries and with most of the important trading partners of Switzerland, and a number of limited treaties for sea and air enterprises.

xi. 1962 Decree on Misuse of Treaties

Since 1962, Switzerland had in effect internal law measures designed to prevent misuse of income tax treaties. The internal law was revised at the end of 1998.

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

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

xii. 1998 Circular Letter

The new 1998 circular letter limits the application of the old 1962 rules. Active Swiss companies, listed companies, and pure holding companies may transfer more than 50% of the gross treaty benefit income in the form of deductible payments if such payments are commercially justified. In addition, these companies are no longer forced to pay out a dividend of at least 25% of their gross treaty benefit income, if at the level of the Swiss company payment of Swiss withholding tax on the undistributed or hidden reserves is not endangered in the future.

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

xiii. Special Rule for Companies with Contacts in the U.S.

Neither the 1962 decree nor the amending circular letter of 1998 is applicable in the context of a company having contacts with the U.S. The new U.S.-Switzerland treaty of 1996 has overruled the application with its extensive limitation on benefits provisions. Consequently, Swiss companies investing in the U.S. must look exclusively to the tax treaty to determine whether the treaty is being misused.

xiv. Holding Company Activities

A Swiss holding company might generally be attractive, because its activities are not strictly limited to holding activities. Thus, as long as (i) the main purposes of the holding company are holding activities (reflected in the articles and in fact) and (ii) either the income or the asset test as described above in Paragraph 4.B.i are met, the holding company can perform additional functions as follows:

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

As a consequence, a Swiss holding company can employ personnel and it may rent office space. Due to the tax exemption on the cantonal/communal level, income derived from the foregoing activities (*i.e.*, interest, royalty and management income) is only taxable on the federal level, *i.e.*, 8.5% (before taxes) or approximately 7.8% after taxes. Nonetheless, because the law does not contain total clarity, it is viewed to be prudent to obtain a ruling from the tax authorities with regard to substantially other than holding company functions.

It has to be noted that discussions are under way regarding the tax exemption of certain holding company activities. The outcome is unclear but there could be consequences to the future taxation of Swiss holding companies (see Paragraph C.v of this chapter, below).

C. Additional Tax Related Issues

i. U.S. Check-the-Box Rules

In Switzerland, companies are in most cases incorporated either as an Aktiengesellschaft or as a GmbH. Since the Swiss Aktiengesellschaft qualifies as a per se corporation for the U.S. check-the-box rules, these rules can only be used in connection with a Swiss GmbH. Swiss holding companies can be set up in the form of a Swiss GmbH. Before the revision of the GmbH law,

there was a limitation of a GmbH's share capital of CHF 2 million. As of January 1, 2008, a GmbH's share capital does not have a limitation. Although the new law brought substantial changes, the "new" Swiss GmbH is still applicable for the U.S. check-the-box rules.

ii. Swiss Ruling Policy

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

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

iii. Swiss Debt-Equity Rules

In 1997, the Swiss federal tax administration issued new and detailed rules regarding the debt-equity ratios of Swiss companies. Based on these rules, the underlying equity of participations and immovable property must be 30%, based on the fair market value of the assets. For other assets, the respective underlying equity is in the range between 0% (cash), 15% (claims) and 50% (non-listed minority shareholdings).

If the above mentioned rules are not fulfilled, the missing equity portion will nevertheless be taxed as equity and, if interest payments to related parties exceed (in combination with an interest rate fixed annually) the so calculated maximum deductible interest expense, the excess portion of such payments would not be tax deductible and recharacterized into a hidden dividend distribution.

iv. Use of Swiss Holding Companies

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

- No activity clause is requested for investments, *i.e.*, participations owned by a Swiss holding company can also be qualified as a portfolio investment;
- No "subject to tax clause" exists for underlying participations;
- No holding period is requested for investments in connection with dividend distributions;
- No capital gains tax upon sale of at least 10% participations;
- Income other than dividend income is only subject to the 8.5% federal corporate income tax (7.8% after taxes), whereas such income is fully taxable at rates between 30-40% in other E.U. Member States; and
- Switzerland does not have any C.F.C. legislation.

v. <u>Future Taxation of Swiss Holding Companies</u>

With regard to the future taxation of Swiss holding companies, discussion is underway within the framework of the third round of Swiss corporate tax reform. Certain tax practices in Switzerland have been criticized by the European Union since 2007. Furthermore, the international pressure on certain low or no taxation rules has intensified in recent years.

On May 17, 2013, an interim report was published by the steering committee recommending the replacement of or changes to the cantonal tax regimes (holding, mixed and domiciliary companies) by several measures. The most important changes might be the end of domiciliary and mixed companies and the cantonal/communal taxation of income other than dividends and capital gains from more than 10% subsidiaries. Today such income is taxed only on the federal level, and in the future, it is likely to be taxed on the other levels as well. However *e.g.* in the canton of Zug the increase in corporate income tax would be only in the range of 4.5%. It is hoped that these measures (*e.g.* license boxes) will enhance the position of Switzerland as an attractive location for foreign investors.

The specific measures of the Swiss corporate tax reform remain uncertain; however, the interim report provides some guidance and outlines a strategy that serves as a basis for ongoing discussion. The proposals included in the interim report are as follows:

- The introduction of new special tax regimes such as license boxes ("I.P. boxes") and the notional interest deduction on equity;
- A general reduction of cantonal corporate income tax (see Paragraph 4.B.i),
- A grant of authority for cantons to abolish cantonal corporate wealth tax (see Paragraph 4.B.ii);
- The improvement of the participation exemption;
- The abolition of stamp duty on the issuance of equity (see Paragraph 4.B.iii);
- The extension of the tax loss carryforward period and group loss; and
- The amendment of the withholding tax regime for intragroup financing (see Paragraph 4.B.viii).

The final report from the steering committee is expected in fall 2013. However, the implementation of any changes will most likely take 5-7 years.

At this point, the outcome of the Swiss corporate tax reform is uncertain and it remains to be seen what consequences will result for future taxation of Swiss holding companies. However, the steering committee pointed out that it is important to strengthen the competitiveness of Switzerland in tax matters and to maintain the legal certainty and predictability of the Swiss tax system.

5. BELGIUM

Belgium does not provide a privileged tax regime for holding activities (such as the former 1929 Luxembourg holding company). However, a Belgian company subject to Belgian corporate income tax or a Belgian branch of a foreign company is eligible, under appropriate circumstances, for benefits of the Belgian participation exemption, which provides a favorable tax regime for dividends and capital gains from the disposition of shares of stock in subsidiary corporations. However, since the regulations were amended in 2007 (Royal Decree of May 23, 2007), the Private P.R.I.C.A.F. offers certain opportunities as an investment vehicle for collective investment in equity (shares).

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

A. Corporate Income Tax

i. General Regime

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

ii. Participation Exemption – General

Under the participation exemption, qualifying dividends received by a Belgian company are eligible for a 95% deduction, and capital gains realized on the disposition of qualifying shares of stock are eligible for either a 100% exemption (if the recipient company qualifies as a Small or Medium-sized Enterprise or "S.M.E.") or taxation at a special rate of 0.4% (other corporate recipients).

iii. Dividends Received Deduction

The full amount of all dividends received – net of foreign withholding tax – is first included in taxable income with the other taxable income items of the Belgian company. Ninety-five percent of qualifying dividends are subsequently deducted, but only in case and to the extent that the initial computation results in a positive balance. In principle, the remaining 5% of dividends received is part of the taxable income of the Belgian company. If the net result of the Belgian company's other activities in the current year is negative, none or only part of the qualifying dividends can be deducted. Moreover, in certain instances, any negative result of the Belgian company derived from other activities may be wholly or partially "absorbed" by dividends qualifying for the participation exemption. In those instances, the absorbed portion of operating losses is not eligible for carryover to subsequent tax years. The "unused" portion of the

dividends received deduction would then be permanently lost, as no carryforward or carryback is available. While this was the general rule until the *Cobelfret* case was decided (see below), the situation is now more nuanced.

On April 25, 2003, the Brussels Tax Court ruled that the pre-*Cobelfret* mechanism ran afoul of the requirement under the E.U. Parent/Subsidiary Directive that at least 95% of dividends received must be exempt from tax. The Antwerp Tax Court also judged that the Belgian dividends received deduction regime is contrary to the E.U. Parent/Subsidiary Directive (decisions dated November 19, 2004 and December, 16 2005). Moreover, three Belgian jurisdictions have submitted prejudicial questions to the European Court of Justice (E.C.J.) regarding the compatibility of the Belgian regime with Parent/Subsidiary Directive and with Articles 43 (now 49) and 48 (now 54) of the Treaty on the Functioning of the E.U. or "T.F.E.U." (successor of the Treaty of Rome) regarding freedom of establishment.

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

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

- In a Member State of the European Economic Area ("E.E.A."), including Belgium, but for dividends declared before 1994, non-E.U. Member States of the E.E.A. are not taken into consideration as the E.E.A. entered into effect on January 1, 1994;

- In a country with which Belgium has concluded a bilateral tax treaty that contains an equal treatment clause (functional equivalent of Article 22(1)(c) of the Belgium-U.S. Income Tax Treaty currently in effect); or

- In another country, provided that Article 56 of the Treaty of Rome applies (free movement of capital) to the (share) capital represented by the shares that produce the dividends.

In addition, Belgium disallows the dividends received deduction for dividends received by a Belgian company to the extent that its taxable income (profit) consists of certain non-deductible expenses. However, according to Article 205, §2, Sections 2 and 3 ITC, the disallowance does

not apply to dividends stemming from qualifying subsidiaries established in E.U. Member States. In its Circular Letter of May 19, 2010, the carve-out was extended to dividends from sources mentioned in the first two bullets above. Pursuant to Article 45 of the Law of April 14, 2011, the non-applicability of the disallowance to qualifying E.E.A.-source dividends is enshrined in the statute.

According to a ruling of February 1, 2011 from the Tribunal of First Instance in Brussels, the rule that excess amounts of dividends stemming from subsidiaries in non-E.E.A. countries with which Belgium does not have a bilateral tax treaty in force providing for an equal treatment provision, cannot be carried over does not run afoul of the Belgian constitutional non-discrimination rule. In the case at hand, the tax administration had allowed a taxpayer to carry over excess dividends from a Japanese subsidiary of a Belgian holding company — as there is an equal treatment provision in Article 23(2)(a) of the Belgian-Japanese bilateral tax treaty — but refused to allow the carry-over of Taiwanese and (South) Korean dividends, because in the treaties with Taiwan and Seoul no equal treatment clause is contained. Before the Brussels Tribunal, the taxpayer claimed that the aforementioned distinction ran afoul of the Belgian non-discrimination rule of Articles 10 *juncto* 172 of the Belgian Constitution. However, the Tribunal sided with the tax administration, arguing that the difference between an E.E.A.-source dividend and a "third country dividend" is based upon an objective criterion, hence permissible. Legal doctrine is criticizing the ruling of the Brussels Tribunal and it is likely that the taxpayer will appeal the ruling and the matter may well end up before the Belgian Constitutional Court.

a. Minimum Value of Participation

Dividends distributed by a subsidiary are eligible for the dividends received deduction if the corporate recipient owns at least 10% of the nominal share capital of the subsidiary or, alternatively, the acquisition price (value) for the holding in the subsidiary was at least €2.5 million. Since January 1, 2011 the requirement that the shares generating the dividend income be booked as a "financial fixed asset" in the commercial balance sheet no longer applies.[20]

b. Minimum Holding Period

A minimum holding period of one uninterrupted year is required in order for the dividends received deduction to apply. The minimum holding period of one uninterrupted year may occur partly before and partly after the dividend distribution. Moreover, the Belgian holding company is required to have full legal title to the shares. A so-called "right of *usufruct*" to the shares (a form of economic ownership to the dividends generated by the shares that exists for a limited period of time and is separate from the capital interest) does not suffice. Authoritative legal doctrine is of the view that the minimum holding period applies to the minimum (value of)

[20] In November 2009, the E.U. Commission issued a reasoned opinion (*i.e.,* the second step of an infringement procedure) asserting that the requirement imposed by Belgium – that dividends received are 95% exempt only if the income-producing shares pertain to a "financial fixed assets" – ran afoul of the E.U. Parent-Subsidiary Directive in that it added a condition to the dividends received deduction that was not permissible under the Directive. Belgium was forced to give up this condition, at least for dividends from participations as defined in the Directive. As was the case in other, similar situations, Belgium made no distinction between qualifying dividends under the Directive and other dividends when it brought its legislation in line with the E.U. requirements.

participation-condition as described *sub* a above; in other words, dividends stemming from shares that were acquired less than one year before the distribution of the dividends, should qualify for the dividends received deduction provided the Belgian holding company had held on to 10% or 2.5 million euros worth of shares for one uninterrupted year immediately preceding (or partly before and partly after) the dividend distribution.

c. **Subject to Comparable Tax**

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

Pursuant the Royal Decree of February 13, 2003, the Belgian tax authorities published a list of jurisdictions that fail the "normal tax regime-test" or the "not substantially more advantageous tax regime-test." This list includes the following jurisdictions, which may be modified from time to time:

Afghanistan	Aldernay	Belize	Bosnia and Herzegovina
Burundi	Cape Verde	Central African Republic	Comores
Cook Islands	Cuba	Dominica	Equatorial Guinea
Gibraltar	Grenada	Guernsey	Guinee Bissau
Haiti	Herm	Iran	Iraq
Jersey	Kiribati	North Korea	Laos
Liberia	Liechtenstein	Macau	Maldives
Isle of Man	Marshall Islands	Mayotte	Federated States of Micronesia
Monaco	Montserrat	Namibia	Niue

Oman	Panama[21]	Saint Christophe and Saint Nevis	Santa Lucia
St. Pierre de Miquelon	Saint Vincent and the Grenadines	Samoa	American Samoa
Saõ Tomé and Principe	Seychelles	Somalia	Trinidad and Tobago
Tuvalu	Uzbekistan	British Virgin Islands	(American) Virgin Islands.

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

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

d. Proscribed Business Activities

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

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

A "treasury company" is defined as a company mainly or solely engaged in portfolio investment other than cash pooling.

An "investment company" is defined as a company the purpose of which is the collective investment of capital funds, *e.g.,* S.I.C.A.V.'s, S.I.C.A.F.'s and comparable entities.

Under certain conditions, the dividends received deduction is nevertheless available for E.U.-based finance companies and for investment companies.

[21] Prior to the Royal Decree of January 27, 2010, Panama was on this list, but the Belgian Ruling Commission had confirmed in a specific case that a Panamanian subsidiary of a Belgian corporation satisfied the subject to comparable tax-test (Ruling No. 700.383 of November 13, 2007).

e. **Offshore Activity**

The dividends received deduction is not available for dividends distributed by a company to the extent that the non-dividend income the latter receives originates in a country other than the country where the distributing company is a resident for tax purposes and such income is subject in the latter country to a separate tax regime that deviates from the normal tax regime.

f. **Certain Foreign Branch Income**

The dividends received deduction is not available for dividends distributed by a company to the extent that it realizes profits through one or more foreign branches that are subject to a tax assessment regime substantially more advantageous than the tax regime to which such profits would have been subject in Belgium, *i.e.,* the Belgian corporate income tax regime for nonresident companies. Under certain conditions, the dividends received deduction is, however, available for dividends distributed by Belgian companies with foreign branches and also for dividends distributed by companies (established in certain treaty jurisdictions) availing of a foreign branch.

Dividends stemming from non-Belgian branch profits qualify for the dividends received deduction to the extent that either (i)the branch profits are subject to a 15% corporate income tax or (ii) the company and its branch are located in another E.U. jurisdiction.

g. **Intermediary Companies**

The dividends received deduction is not available for dividends distributed by an intermediary company, other than an investment company, that redistributes dividend income derived from tainted participations. As a result, if at least 90% of a dividend received from an intermediary company is funded by its own receipt of dividends from subsidiaries located in third countries, the dividends received deduction may be disallowed if no deduction would have been permitted had the lower-tier companies paid dividends directly to the Belgian corporation. In other words, a group cannot "launder" tainted dividends by washing them through an intermediary located in an acceptable jurisdiction.

As a safe harbor rule, participations in companies residing in a country with which Belgium has concluded a tax treaty and that are listed on a recognized E.U. stock exchange are always eligible for the participation exemption. These companies must be subject to a tax regime comparable to the Belgian tax regime, without benefiting from a regime that deviates from the normal tax regime.

With respect to investments in or through hybrid entities (*e.g.*, U.S. partnerships) the Belgian Ruling Committee issued several favorable rulings. In most instances, the Ruling Committee confirmed that for Belgian tax purposes one can look through the foreign hybrid entity and apply, *inter alia*, the participation exemption to the extent it would apply if the underlying participations had been held directly by the Belgian holding company.

h. **Purchased Dividend**

The term "purchased dividend" is used to describe the following fact pattern. At the time a target company ("Target") is being acquired by an acquiring company ("Acquirer") it has substantial earnings and profits on its balance sheet and the Acquirer pays "dollar for dollar" for such earnings and profits. Shortly after completion of the acquisition, the Acquirer has the Target to distribute substantially all of the pre-acquisition earnings and profits in the form of a dividend. In most instances, the Acquirer will subsequently utilize the proceeds of the dividend distribution to reimburse an equivalent portion of the acquisition debt.

Based on an Advice from the Belgian Commission for Accounting Standards (C.A.S.), purchased dividends should not go through the Acquirer's profit and loss account, but should rather be utilized to reduce the book value (purchase price) of the Target-shareholding in the balance sheet of the Acquirer.[22] As a result, the purchased dividend is not included in the Acquirer's financial income, hence it does not need to be deducted for 95% by virtue of the dividends received deduction. As a result, the Acquirer is not subject to tax on the non-deductible portion of 5% of the purchased dividend.

However, in a ruling of January 20, 2010 the Tribunal of First Instance of Bruges ruled otherwise and found that the purchased dividend had to be treated as taxable (financial) income for the Acquirer. As a result, only 95% of that amount was tax deductible by virtue of the dividends received deduction, whereas 5% has effectively subject to tax in the hands of the Acquirer. The Acquirer appealed the ruling before the Court of Appeal of Ghent, but the latter court confirmed the ruling from Bruges (May 17, 2011). Commentators have criticized the rulings, arguing that the purchased dividend cannot be categorized as "income" for the Acquirer because the notion "income" requires that the beneficiary of the income is enriched, which is not the case with a purchased dividend.

i. **Other Aspects**

Interest and other expenses relating to the acquisition and/or the management of shares in, or capital contributions to, either a Belgian or a foreign subsidiary company remain in principle fully deductible to the extent that they meet regular arm's-length criteria. There is no general minimum debt-to-equity ratio. Finally, the participation exemption applies to payments received in connection with a liquidation or redemption of shares.

Pursuant to the law of June 23, 2005 and effective January 1, 2006, Belgian corporations are entitled to a notional interest deduction ("N.I.D."). The N.I.D. is a tax deduction for fictitious interest owed on the corporation's equity as it appears in its commercial balance sheet. The notional interest rate is restated every year. For 2012, the N.I.D., rate was capped at 3.00% (3.5% for S.M.E.'s). For fiscal year 2013, the rule regarding the method of computation of the N.I.D. rate was changed, resulting in an N.I.D. rate of 2.74% (3.24% for S.M.E.'s). As an austerity measure, unused portions of the N.I.D. can no longer be carried over to subsequent tax years.[23] To curb perceived abuses, the amount of equity that serves as the basis for computation

[22] Advice No. 151/2 of March 1995.

[23] Law of December 13, 2012 on Tax and Financial Provisions (Belgian State Gazette December 20, 2012, 4th Edition). Transitional provisions are available regarding the right to utilize any existing "inventory" of carried over N.I.D. going forward.

of the N.I.D. is adjusted by deducting, *inter alia*, the commercial book value of participations that qualify for the participation exemption.

The law of April 27, 2007 introduced a new tax deduction for patent income, amounting to 80% of the gross income deriving from the patent, thereby resulting in effective taxation of the income at the rate of 6.8% (rounded). This tax incentive is aimed at encouraging Belgian companies and establishments to play an active role in patent research and development, patent ownership and manufacturing of products based on those patents. The tax deduction applies to new[24] patent income.

j. Ruling Practice

The Belgian tax administration must, upon the taxpayer's request, issue an advance tax ruling on, *i.e.*, the availability of the dividends received deduction and especially on the question whether one or more anti-abuse provisions apply in a particular case. No such ruling will be granted, however, with respect to jurisdictions or types of companies listed as non-qualifying in the official tax haven list (see, Paragraph A.iii.c of this chapter, above). In principle, the tax authorities must issue their ruling within three months of receipt of a complete and exhaustive ruling application.

iv. Capital Gain Exemption

Under the participation exemption, net capital gains realized by a Belgian resident company (or the Belgian branch of a foreign company) on shares in a Belgian or a foreign subsidiary are either (a) taxed at a special rate of 0.4%, or (b) fully exempt from Belgian corporate income tax (if the recipient is a corporation qualifying as an S.M.E.), fully exempt from Belgian corporate income tax (if the recipient is a corporation qualifying as an S.M.E.), provided the dividends on the shares qualify for the tests described above under Paragraphs A.iii.b through A.iii.g of this chapter, relating to the dividends received deduction. However, if a foreign subsidiary derives dividends (directly or indirectly) from one or more companies not meeting the anti-abuse requirements for the dividends received deduction, the entire capital gain on the disposition of the shares of the subsidiary would be taxable.[25] Only the net amount of eligible capital gains is exempt from tax, in other words, costs and expenses incurred by the corporate shareholder in connection with the realization of the shares of stock, must be deducted from the exempt amount of capital gains. Hence, such costs and expenses cannot be deducted from ordinarily taxed income and save additional corporate income tax. See also Paragraph A.v of this chapter, below.

a. No Minimum Ownership; One Year Holding Period Requirement

The minimum participation requirement that exists for dividends (10% of the capital or acquisition value of not less than €2.5 million) applies for capital gains. However, the same one

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[24] In order to be considered as new, the income, in relation to patents, must not have been used by the company, a licensee or a related enterprise for the purpose of the supply of goods or services to third parties prior to January 1, 2007.

[25] This is the official view of the Belgian Revenue; however, this view is contested.

year holding period requirement that exists for the dividends received deduction (see Paragraph A.iii.b of this chapter, above), now applies for the exemption of capital gains on shares (effective November 28, 2011) pursuant to the Program Law of March 29, 2012. The exemption applies only to the extent that the capital gain realized on the shares exceeds the tax book value of these shares. The capital gain exemption is granted by a direct elimination of the net gains from taxable income. Consequently, the limitation connected with the method used for granting the dividends received deduction does not come into play and loss utilization is not adversely affected. This means that losses derived from other activities of the Belgian holding company do not absorb the participation exemption on capital gains.

Effective tax assessment year 2014 (fiscal years ended on or after December 31, 2013[26]), if the recipient corporate taxpayer does not qualify as an S.M.E.,[27] the capital gains – computed in accordance with the same rules – are no longer fully exempt from corporation tax, but instead, subject to a separate taxation at the rate of 0.4%, regardless of the availability of N.O.L.'s or other tax attributes or tax assets.[28] The rate of 0.4% is increased with the austerity tax of 3%, bringing the aggregate effective rate to 0.412% of the capital gain.

Effective 2013, capital gains on shares that fail the one year holding-test are taxed at a special rate of 25% (25.75% including the austerity tax of 3%).

The one year holding-requirement does not apply to qualifying financial institutions in connection with shares pertaining to their trading portfolio. Capital gains on such shares continue to be 100% exempt from corporate income tax, even if the one year holding-requirement is not met. Transfers from the trading portfolio to the financial assets will normally qualify for the full exemption for capital gains (even if the one year holding-requirement is not satisfied); conversely, transfers from the financial assets to the trading portfolio will be subject to the 25.75% capital gains tax if the one year holding-requirement is not satisfied, and to the 0.4% tax if the one year holding-requirement is satisfied by the taxpayer does not qualify as an S.M.E.

b. Options

If a Belgian company purchases stock below fair market value pursuant to the exercise of a call option or a warrant, any subsequent gain realized upon the disposition of the shares of stock qualifies, in principle, as a tax-exempt capital gain. The exemption does not apply to the sale of the option or the warrant. If the call option itself were sold at a gain, the gain would not be eligible for exemption.

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26 Amendments to the closing date of the fiscal year made on or after November 21, 2012 will have no effect on the applicability of the 0.412% tax on capital gains.

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

28 Program Law of December 27, 2012 (Belgian State Gazette December 31, 2012).

c. Unrealized Gains

Unrealized capital gains are not taxable if the capital gain is not expressed in the accounts. If the capital gain would merely be expressed in the Belgian company's accounts, said gain is not taxable so long as it is booked in a non-distributable reserve account. Upon later realization of such capital gain, the non-distributable reserve account disappears without triggering corporate income tax.

d. Capital Losses

As a counterpart to the exemption of capital gains, capital losses on the disposition of shares are not tax deductible. However, the loss incurred in connection with the liquidation of a subsidiary company remains deductible up to the amount of the paid-up share capital of that subsidiary. Corporate taxpayers are also not allowed to deduct any capital losses on the disposition of shares that are subject to the 0.412% tax on capital gains (see Paragraph A.iv.a of this chapter, above).

e. Deductible Expenses

Interest paid by a Belgian company is generally tax deductible provided the general arm's length criteria and specific debt-to-equity rules are complied with. There are a few exceptions.

Pursuant to the Law of June 22, 2005, capital gains are exempt only for their net amount, *i.e.*, the gross capital gain minus costs and expenses incurred in connection with the realization of the gain (*e.g.*, brokerage fees, stamp duties, etc.). In a Circular Letter of April 6, 2006, the Belgian tax administration has commented on the limitation of the exempt amount of the capital gains on shares. The Circular Letter contains, *inter alia*, a list of costs and expenses that must be deducted from the gross amount of the sales proceeds of the shares in order to compute the net amount of the capital gain that is eligible for exemption from corporate income tax. Among the costs and expenses that must be deducted from the gross sales proceeds of a participation are:

- Costs of publicity (advertisements, etc.);
- Fees of a civil law notary;
- Brokerage fees;
- Financial costs, *i.e.,* foreign exchange losses;
- Financial discounts;
- Stamp taxes;
- Export levies;
- Insurance or other coverage costs;
- Commission fees;
- Advisory fees;
- Consultancy costs;

- Transportation costs;
- Technical audit/inspection costs (may include cost for a vendor due diligence);
- Fees of experts, appraisers, etc.

The rationale behind this rule is to curtail the use of a double dip that existed until the Law of June 22, 2005 entered into effect (tax assessment year 2007, *i.e.*, fiscal years beginning on or after January 1, 2006): on the one hand the gross amount of the sales proceeds of the shares was used to determine the exempt capital gain on shares, and on the other hand, all costs and expenses incurred with the sale of the shares were deductible from other ordinarily taxable income of the parent company.

Pursuant to the Law of March 29, 2012 (Article 147) the previously existing thin capitalization rule (Article 198, 11°, I.T.C.) was severely amended. The previously existing 7:1 debt/equity ratio was replaced by a 5:1 ratio and in addition to interest beneficially owed to low-tax and tax haven lenders, all interest beneficially owed to companies of the same group are now subject to the thin cap rule. Because the government did not want this new thin cap rule to apply immediately to Belgium-based treasury centers of (predominantly U.S.-headquartered) multinational groups of companies, qualifying treasury centers are allowed to offset (or net) interest owed to group companies against interest received from group companies and only the excess amount of net interest owed to group companies, if any, will be subject to the 5:1 thin cap rule.

B. Withholding Tax on Distributions

i. To Belgium

Dividends distributed to a Belgian company are, in principle, subject to a dividend withholding tax at the domestic rate of the country in which the distributing company is established. In most situations, this rate is reduced or eliminated by virtue of a bilateral tax treaty or the E.U. Parent/Subsidiary Directive. With the exception of investment companies, Belgium does not grant a tax credit for foreign withholding tax imposed on dividends.

ii. From Belgium

In principle, all dividends distributed by Belgian companies to both resident and nonresident shareholders are subject to withholding tax of 25%. For dividends "paid or awarded" in the course of 2012, a reduced rate of 21% was available for dividends relating to shares issued on or after January 1, 1994, provided that (i) the shares were publicly issued or (ii) if the shares were not publicly traded, a number of conditions were met.

A full exemption of Belgian withholding tax applies on the distribution of dividends to a parent company established (i) within the E.U. (including Belgian companies) or in a country with which Belgium has concluded a bilateral tax treaty containing an exchange of information provision, and which holds at least 10% of the capital of the Belgian resident distributing

company.[29] If a qualifying parent company holds or has held a qualifying participation, all additionally acquired shares will also qualify, even though the one-year holding period may not be met with respect to such additional shares.

iii. *Denkavit* Case

Following the ruling from the E.U. Court of Justice in the *Denkavit* case, Belgium abandoned the condition that the parent must have held a participation of at least 10% uninterruptedly during a period of at least one year preceding the distribution of the dividend. Therefore, the parent may hold the 10% participation for one entire year, which may occur partly before and partly after the dividend distribution. If the one-year period has not entirely elapsed at the time the dividend is paid, the Belgian distributing company is allowed to pay out the net dividend only, *i.e.,* the gross dividend minus an amount equal to the dividend withholding tax that would apply if the one-year holding period is not respected. If the latter occurs, the amount of withholding tax that becomes due, increased with interest for late payment, must be paid to the Belgian treasury by the dividend distributing company.

Unlike the participation exemption, the exemption from dividend withholding tax is subject to the conditions mentioned in the E.U. Parent/Subsidiary Directive with respect to the legal form, the E.U. tax residency, and the parent company's compliance with a subject-to-tax requirement. As a result of the amendment of the E.U. Parent/Subsidiary Directive, several types of entities that were not eligible for the withholding tax exemption are now included in the list, most notably the European Company or *Societas Europaea* ("S.E."). The legal form requirement does not apply to dividends paid to Belgian entities that are subject to Belgian corporate income tax.

iv. Liquidation and Redemption Distributions

As a separate matter, the dividend withholding tax rate is 10% in the case of a liquidation[30] of a Belgian. At the time of writing, the Belgian government has announced that the 10% rate for liquidation proceeds will be abandoned effective October 1, 2014. Distributions to shareholders made pursuant to a resolution by the company to redeem or buy back its own stock from shareholders have been subject to a preferential withholding tax regime for many years (first at 0%, then at 10%), but that preferential regime was abandoned in 2012, effective January 1, 2013. Distributions pursuant to liquidations and redemptions are also eligible for rate reductions or exemptions from withholding tax on the basis of the bilateral tax treaties concluded by Belgium, the E.U. Parent/Subsidiary Directive or the unilateral extension of the E.U. Parent/Subsidiary withholding tax exemption discussed above.

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[29] The Belgian tax authorities take the view that the agreement between Belgium and Taiwan does not qualify as a bilateral tax treaty, hence the reduction of dividend withholding tax to 0% for dividends distributed by a Belgian company will not be available to the extent such dividend is distributed to a Taiwanese parent company.

[30] In its ruling of October 18, 2012, the E.C.J. decided that a merger involving a dissolution but no liquidation of the absorbed company (because all the assets and liabilities of the disappearing company are transferred to the surviving company by operation of the law) does not qualify as a "liquidation" within the meaning of Article 4 of the Parent-Subsidiary Directive, which carves out liquidation distributions from the scope of the Directive. Hence, the exemption from dividend withholding tax that is imposed by the Directive must be granted to "distributions" made or deemed to be made when two or more companies are merged.

i. Refund of Withholding Tax for Non-Resident Investment Funds

Following the ruling of October 25, 2012 of the E.C.J. (Case No. C-378/11), the Belgian tax authorities issued a circular letter[31] regarding the conditions and formalities for non-resident investment funds to obtain a refund of Belgian (dividend or interest) withholding tax, in instances where a Belgian resident investment fund would be allowed to credit any Belgian withholding tax and obtain a refund to the extent the Belgian fund is not subject to corporate income tax on its investment income. As far as past dividends are concerned, the circular letter limits requests for refunds to dividends paid or awarded between January 1, 2007 and December 31, 2012, to investments funds covered by E.U. Directive 85/611/EEC of December 20, 1985, the provisions of which are now incorporated into Directive 2009/65/EC and transposed into Belgian law by virtue of the Law of August 3, 2012. Only the amount of withholding tax that cannot effectively be credited or reimbursed to the investment fund in the state of residence of the fund is eligible for a refund in Belgium.

Foreign investment funds may avail themselves to a 5-year or 10-year period to claim the refund, depending on when the Belgian withholding tax was initially paid (on or after January 1, 2011, the period is 5 years following the date of payment of the withholding tax; prior to January 1, 2011 the period is 10 years following the date of payment of the withholding tax). The circular letter does not mention whether or not interest for late payment will be allowed, but authoritative legal doctrine and case law from the Constitutional Court establish authority to believe that the refund of withholding tax is eligible for interest payment.

C. Withholding Tax on Outbound Interest Payments

Interest paid by any Belgian company is, in principle, subject to interest withholding tax of 25% (in 2012, the rate was still 21%). This domestic rate can often be reduced by virtue of bilateral tax treaties, several domestic exemptions as well as the E.U. Interest and Royalty Directive as implemented in Belgium.

D. Capital Duty

Pursuant to the Law of June 23, 2005, the rate of the capital tax is set at 0%[32] for all contributions to share capital occurring on or after January 1, 2006.

E. V.A.T.

On the basis of the case law of the European Court of Justice, a distinction is made between so-called “active” and “passive” holding companies.[33] A passive holding company has no economic activity that gives entitlement to credit input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or

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[31] Ci.R.H. 233/623.711, AAFisc No. 11/2013, dated March 4, 2013.

[32] Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

[33] A.o., C-77/01, April 24, 2004, EDM.

participations. An active holding company, however, is involved in its subsidiaries' management. To the extent that its activities are neither exempt nor outside the scope of V.A.T., an active holding company can credit input V.A.T. against output V.A.T.

Based on a recent answer from the Belgian Minister of Finance on a Parliamentary Question,[34] even V.A.T. incurred in connection with the sale of shares may, under appropriate circumstances, be creditable and refundable. This new insight is derived from the E.C.J.s ruling of October 29, 2009, Case Nr. C-29/08 *Skatteverket vs. AB SKF*. First, one should determine whether or not there is in principle a direct relationship between a "previous" transaction (for example, an input transaction on which input-V.A.T. is chargeable) and a "subsequent" transaction (for example, an output transaction that is subject to output-V.A.T.). If that is the case, the input-V.A.T. can be credited. Conversely, if there is a direct relationship between an input transaction and an output transaction that is either exempt from V.A.T., or outside the scope of V.A.T., the input-V.A.T. is not creditable (as was the situation in E.C.J. Case No. C-4/94 of April 6, 1995 *BLP Group*). However, if no direct relationship exists between the input transaction and any output transaction, the input-V.A.T. may still be creditable, provided that the cost for the input-services on which input-V.A.T. was due is part of the general expenses of the taxpayer and is included in the price charged by the taxpayer for goods delivered or services rendered. This principle was formulated in the *Skatteverket vs. SKF*-Case of the E.C.J. of 2009. Where the Belgian tax administration accepted that input-V.A.T. could be creditable in the event of an issuance of new shares or the purchase of shares. Until recently, they follow the same reasoning for V.A.T. incurred in connection with the sale of shares. However, according to the Minister of Finance, no V.A.T. credit is available if the cost of the input-transaction on which V.A.T. was charged is included into the sales price of the shares which is either exempt or out of scope. Only if the cost of the input transaction is included in the price of output-transactions that are subject to V.A.T. (*i.e.,* neither exempt, nor out of scope) will the input-V.A.T. be credited and recovered.

F. Private P.R.I.C.A.F.

Private P.R.I.C.A.F.'s are private (*i.e.*, non-listed), collective investment undertakings, aimed at investing in non-listed companies. In principle, a private P.R.I.C.A.F. is not a holding company *per se* and is not allowed to acquire the control of a company (minor derogations are allowed).

A Private P.R.I.C.A.F. can take the form of a company limited by shares or a limited partnership with a share capital. It is a closed-end fund, established for a period not exceeding 12 years for "private investors", *i.e.*, persons investing at least €50,000. The Private P.R.I.C.A.F. must have at least six "private investors".

The Private P.R.I.C.A.F. may invest in a broad range of financial instruments issued by non-listed companies: shares, bonds and other debt instruments, securities issued by other undertakings for collective investment, derivative financial instruments (subscription rights, options, etc.) and loans (*e.g.*, the Private P.R.I.C.A.F. may serve for mezzanine financing). Other investments are either partially and/or temporarily authorized or prohibited.

[34] Parl. Question, No. 299 of January 12, 2010 (Brotcorne), Q&A, Chamber 2009-2010, No.52-102, 107.

The Private P.R.I.C.A.F. is subject to corporate income tax, but its taxable basis deviates from the normal corporate income tax regime and is limited to certain elements (non-at arm's length benefits received, non-deductible expenses including payments in lieu of dividends under stock-lending transactions), such that in principle, the Private P.R.I.C.A.F. does not pay income taxes.

Dividends distributed by a Private P.R.I.C.A.F. are liable to a 25% or 21% (under certain conditions) withholding tax. However, distributions stemming from capital gains realized on shares by the Private P.R.I.C.A.F. are exempt from withholding tax, as well as redemption premiums or liquidation gains. Under conditions, the dividends distributed by the Private P.R.I.C.A.F. may benefit from the dividends received deduction regime.

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

A. Corporate Income Tax – General

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

B. Participation Exemption

i. In General

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

- Holds at least 5% of the nominal paid-up capital of a company with a capital divided into shares;

- Holds an interest in an "open" limited partnership which gives entitlement to at least 5% of the profits realized by the open limited partnership;

- Holds at least 5% of the participating certificates of a fund for joint account;

- Is a member of a cooperative; or

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

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

The participation exemption does not apply to participations which are held as a mere passive investment (the "motive test"). However, if a participation does not pass the motive test, the participation exemption will nevertheless be applicable if (i) the participation is subject to a "realistic levy" according to Dutch tax standards (the "subject to tax test") or/and (ii) the assets of the participation do not consist direct or indirect for more than 50% of so-called "low-taxed free passive assets" (the "asset-test").

ii. <u>Motive Test</u>

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

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

iii. Subject-to-Tax Test

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

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

iv. Asset Test

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

Assets which qualify as free passive assets are:

- Passive assets which are not necessary for the business activities of the entity holding the assets. Interest bearing bank accounts, loan receivables, passive investments such as bonds and shares could, amongst others, qualify as free passive assets. In this respect it should be noted that real estate -including rights over real estate- is not considered to be a free passive asset, unless the real estate is held by a Dutch exempt investment institution, or a Dutch 0%-taxed investment institution.

- Inter-company receivables, unless they are used by an active group finance company or are financed entirely or almost entirely (90% or more) by third party debt.

- Assets leased to a group company, unless they are used by an active group leasing company or are financed entirely or almost entirely (90% or more) by third party debt.

As mentioned above, both direct and indirect assets of the participation must be taken into account. Consequently, assets of companies in which the participation holds an interest of at

least 5% must be pro rata allocated to the participation. Interests below 5% are in any event deemed to be passive assets. Furthermore, if less than 30% of the assets held by a company consist out of low-taxed free passive assets, all assets -excluding participations- of the company can be allocated to the participation as "good assets".

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

v. Earn-Out and Balance Guarantee Arrangements

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

vi. Expiring Participation

If a qualifying participation falls below the 5% threshold as a consequence of a sale of shares or an issue of new shares to a third party, the participation exemption remains applicable for an additional period of 3 years, provided that the qualifying participation was held for an uninterrupted period of at least 1 year.

vii. Non-Qualifying Participations

In the event that the shareholding will be 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.

viii. Stock Options/Convertible Bonds

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

ix. Hybrid Loans/Profit Rights

As was mentioned above, the participation exemption is also applicable to profits 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 corporate income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporate income tax purposes and in principle will be subject to 15% dividend withholding tax (for a further explanation regarding dividend withholding tax see Paragraph E below). On the other hand, the interest and principal paid on a hybrid loan will be exempt from Dutch corporate income tax and Dutch dividend withholding tax in the hands of a Dutch resident lender if this lender owns a qualifying participation in the borrower or the borrower qualifies as a related entity of the lender. (See Paragraph c.ii of this chapter, below.) Especially in the context of international structures, we note that the exemption for interest received on a hybrid loan by a Dutch lender is not affected by the tax treatment of interest paid by a nonresident borrower. Consequently, even if the foreign borrower is able to deduct the interest in its country of residence the interest received will be exempt from Dutch corporate income tax.

C. Other Aspects

i. Costs/Expenses

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

ii. Base Erosion

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

- Profit distributions or repayments of capital by the taxpayer or a related entity to a related entity or related individual;

- The acquisition of an interest by the taxpayer, a Dutch resident related entity or a Dutch resident related individual in a company which after the acquisition is a related entity; or

- The contribution of capital by the taxpayer, a Dutch resident related party or a Dutch resident related individual in a related entity.

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

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

- The interest is subject to sufficient taxation in the hands of the recipient, and the recipient is not able to offset the interest income with losses of prior years or anticipated losses in the future, unless both the granting of the loan and the business transaction are not based on sound business reasons. Interest will be

subject to sufficient taxation in the hands of the recipient if the recipient is taxed on profits determined under Dutch tax principles at a rate of at least 10%.

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

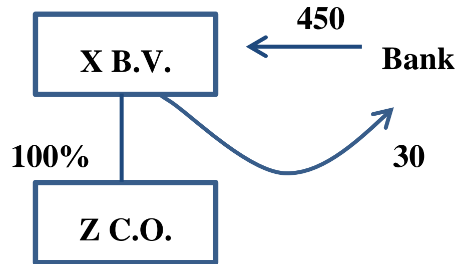
- The taxpayer holds at least one-third of the capital in the other entity,
- The other entity holds at least one-third of the capital of the taxpayer, or
- A third party holds at least one-third of the capital in both entities.

iii. Excessive Debt Financing for Holding Companies

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

The above can be explained through an example:

X B.V. acquired a subsidiary ("Z C.O.") for €400 million and financed the acquisition and its ongoing activities with a bank loan of €450 million. X B.V.s profits before interest expense amount to €25 million and X B.V.s interest expense in respect of the bank loan is €30 million. Normally, without applying Article 13L C.I.T.A., these figures result in a tax loss of €5 million (€25 million profits before interest expense less €30 million interest expense = €5 million loss).



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

Debit	(€x1M)	Credit	(€x1M)
Participations	400	Equity	250
Other Assets	300	Debt	450

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

X B.V.s participation debt amounts to €150 million (€400 million - €250 million). In principle, the interest payable with respect to this participation debt is nondeductible for Dutch corporate income tax purposes. In order to calculate the total amount of nondeductible interest, the participation debt (€150 million) must be divided by the total amount of debt (€450 million), the result of which should be multiplied by the actual interest expense *(i.e.* 150/450 x 30 = €10 million). After taking the €750,000 threshold into account, a total amount of €9.25 million is characterized as nondeductible interest paid, relating to the acquisition of the participation. Consequently, in this example, interest to an amount of €20.75 million is deductible. The result is a taxable profit of €4.25 million (€25 million - €20.75 million) instead of a tax loss of €5 million, which would be realized without the application of article 13L C.I.T.A.

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

Simultaneously with the introduction of Article 13L C.I.T.A., the Dutch thin capitalization rule was abolished, although a non-statutory debt/equity ratio is still applicable under certain circumstances. (See Paragraph D below.)

iv. Dutch Acquisition Holding Company

As of January 1, 2012, new legislation was introduced limiting the deductibility of interest expenses incurred by a Dutch acquisition holding company in connection with a loan taken up to acquire a Dutch target company which post-acquisition would be included in a fiscal unity with the acquiring entity. The benefit of establishing a fiscal unity structure is that the interest paid by the acquisition vehicle would be deductible from the profits of the target company. By forming a fiscal unity the acquisition holding company would be deemed to absorb all assets and liabilities of the target company including its profits. Under Article 15ad C.I.T.A., the interest paid by the Dutch acquisition holding company will be deductible only from the profits of that acquisition company, which generally would be negligible. The limitation applies only to the extent the interest expense exceeds €1 million per year and the acquisition loan exceeds 60% of the acquisition price of the shares in the year of acquisition. In the following 7 years the loan should be repaid at a rate of 5% of the original principal per year, ultimately leaving a loan outstanding equal to 25% of the acquisition price. The nondeductible interest expenses can be carried forward. Article 15 ad C.I.T.A. is applicable to both group loans and third party loans. It also applies to post-acquisition legal mergers and liquidations within a fiscal unity. It seems however, that the adverse consequences of Article 15 and C.I.T.A. can largely be avoided by debt push-downs.

v. Innovation Box

In order to stimulate R&D activities by Dutch taxpayers, apart from expensing costs related to R&D activities in the year incurred, self-developed registered patents and certain other assets for which a so-called "research and development statement" has been requested (together, "R&D

Assets") may be placed in the so-called innovation box. Trademarks are specifically excluded from this beneficial regime. Income generated by way of the R&D Assets will be subject to tax at the statutory rates of 20% to 25% until the development costs incurred in respect of such patents have been recouped. Any income received exceeding such development costs will be taxed at an effective rate of 5%. Income includes royalty income such as license fees and other income stemming from R&D Assets. The innovation box regime applies to income received from related parties and unrelated parties.

vi. Capital Losses

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

D. Tax Rulings

In general, it is possible to obtain advance tax rulings whereby the Dutch revenue confirms in advance the tax treatment of a holding company. It is standard policy that the ruling is subject to the condition that the holding company finances its participations with a minimum of 15% of equity. Even when an advance tax ruling is not obtained, it is advisable to observe this (non-statutory) debt/equity ratio of 85/15.

E. Dividend Withholding Tax

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

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

No dividend withholding tax is levied on dividends paid to non-resident corporate shareholders, if:

- The corporate shareholder is a tax resident of a country within the E.U or the E.E.A. (with the exclusion of Liechtenstein);

- The Dutch participation exemption would have been applicable to the shareholding in the Dutch entity distributing the dividends if the recipient of the dividends would have been a resident of the Netherlands;

- The corporate shareholder does not fulfill a similar function as a Dutch exempt investment institution or Dutch 0% taxed investment institution; and

- The corporate shareholder is the beneficial owner of the dividends.

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

F. Extra-Territorial Taxation and Anti-Abuse Rules

It should be noted that although an exemption from withholding tax may be available as described above under Paragraph E of this chapter, the nonresident corporate shareholder of a Dutch holding entity may be subject to Dutch corporate income tax on the dividends received, if:

- The corporate shareholder owns 5% or more of the shares or a class of shares of the Dutch holding company;

- According to Dutch standards the corporate shareholder does not conduct an enterprise to which the Dutch shares can be allocated; and

- The corporate shareholder holds the Dutch shares with the primary aim or one of its primary aims to avoid the levy of Dutch income tax or dividend withholding tax with its direct or indirect shareholders.

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

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

- The first is that the cooperative holds in direct shareholdings, profit-sharing certificates or has granted profit participating loans with the primary aim or one of the primary aims to avoid the levy of Dutch dividend withholding tax or foreign tax with its direct or indirect

members. In addition, the membership rights cannot be allocated to a member's enterprise.

- The second is that the membership rights are allocated to a member's enterprise and the cooperative is solely included in the structure for the purpose of avoiding an existing Dutch dividend withholding tax liability of a Dutch company.

These anti-abuse provisions are effective as per January 1, 2012, and are mainly aimed at individuals owning a Dutch holding company through an offshore entity. Active foreign companies and private equity funds owning their international operations via a Dutch holding company will generally not be affected.

G. Capital Tax/Stamp Duties

The Netherlands does not levy any kind of capital tax, stamp duties or other registration charges in respect of the issuance or transfer of shares in a Dutch resident company, except under certain circumstances real estate transfer tax ("R.E.I.T."). R.E.I.T. is levied if a purchaser acquires real estate or at least one-third or more of the shares of a "real estate company". A company is considered a real estate company, if more than 50% of its assets consist or consisted one year prior to the acquisition of real estate used for passive investment and at least 30% of its assets consist of Dutch real estate. R.E.I.T. (6%) is levied over the fair market value of the real estate located in the Netherlands.

7. Spain

A Spanish holding company or "*Entidad de Tenencia de Valores Extranjeros*" (better known by the Spanish acronym "E.T.V.E.") is a regular Spanish company subject to a 30% tax on its income, but fully exempt from taxation on qualified foreign source dividends and capital gains.

In addition to these standard features of a holding company, the E.T.V.E. regime offers a substantial advantage vis-à-vis other attractive European holding company locations, as dividends distributed by the E.T.V.E. to non-Spanish resident shareholders are exempt from the Spanish withholding tax on dividends. In addition, capital gains triggered by a nonresident shareholder on the transfer of its interest in an E.T.V.E. are not subject to the Spanish 21% capital gains tax to the extent that such capital gains (indirectly) arise from an increase in the value of the foreign holdings of the E.T.V.E.

The E.T.V.E. is protected by European Union directives such as the Parent/Subsidiary Directive and the Merger Directive and is regarded as a Spanish resident for tax purposes pursuant to Spain's 84 bilateral tax treaties.[35] Spain's broad tax treaty network with Latin America and the European character of the E.T.V.E. make it an attractive vehicle for channeling capital investments in Latin America as well as a tax efficient exit route for European Union capital investments.

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[35] An updated list of the tax treaties entered into by Spain is available at http://www.minhap.gob.es/es-ES/Normativa%20y%20doctrina/Normativa/CDI/Paginas/CDI_Alfa.aspx..

A. Exemption on Qualified Foreign Source Income

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

The exemption applies subject to the fulfillment of certain requirements governing (i) the foreign investments made by the E.T.V.E., as well as (ii) the E.T.V.E. itself.

B. Qualified Foreign Investments

According to Articles 117 and 21 of the C.I.T. Law, dividends and capital gains received by the E.T.V.E. from nonresident subsidiaries will be exempt from Spanish taxation if the following requirements are met:

- The E.T.V.E. holds a minimum 5% participation in the equity of the nonresident subsidiary (and any second-tier subsidiary) or, alternatively, the acquisition value of the interest in the nonresident subsidiary amounts to €6 million;

- The E.T.V.E. directly or indirectly holds the interest in the nonresident subsidiary (and any second level subsidiary) for at least one year;

- The nonresident subsidiary is subject to and not exempt from a tax similar in nature to the Spanish C.I.T. and is not resident in a tax haven country or jurisdiction; and

- Finally, the nonresident subsidiary is engaged in an active trade or business carried on outside Spain.

i. Minimum Participation and Holding Period

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

The 5% participation must be met by the E.T.V.E. on the direct and indirect holding of any first tier (or alternatively, the acquisition value of the interest in the first tier nonresident subsidiary must amount to €6 million) and lower tier subsidiaries.

For the purposes of computing the time during which the participation has been held by the E.T.V.E., foreign participations will be considered to have been held by a newly incorporated E.T.V.E. from the date on which they were held by other companies within the same consolidated group for accounting purposes.

ii. **Subject to and Not Exempt from Tax**

The nonresident subsidiary must be subject to and not exempt from a tax of a nature similar to the C.I.T. Determining the degree of compatibility of foreign tax systems with 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 that the treaty contains an exchange of information clause. It should be noted that all treaties entered into by Spain contain exchange of information clauses.[36]

Finally, nonresident subsidiaries located in one of the following tax haven countries or territories (as established by Royal Decree 1080/1991, as amended) do not qualify for the E.T.V.E. tax exemption regime:[37]

Anguilla
Antigua and Barbuda
Bermuda
British Virgin Islands
Cayman Islands
Cook Islands
Dominica
Emirate of Bahrain
Falkland Islands
Fiji
Gibraltar
Grenada
Guernsey and Jersey
Isle of Man
Jordan
Lebanon
Liberia
Liechtenstein
Macao
Mariana Islands
Mauritius
Monaco
Montserrat
Nauru
Oman
Republic of Cyprus
Salomon Islands
Seychelles
St. Lucia
St. Vincent and Grenadines
Sultanate of Brunei
Turks and Caicos Islands
U.S. Virgin Islands
Vanuatu

It must be pointed out that those countries or territories that enter into an exchange of information treaty or a tax treaty with exchange of information clause with Spain will immediately cease to be deemed a tax haven.

iii. **Active Nonresident Subsidiary**

The nonresident subsidiary must be actively and primarily engaged in an active trade or business carried out abroad; certain passive income may be generated by the nonresident subsidiary to the extent that it does not exceed 15% of its total turnover. In general, any trade or business is

[36] This is a *iuris et de iure* presumption (*i.e.*, the Spanish Tax Authorities will not be able to provide evidence to the contrary).

[37] This would not be applicable to nonresident subsidiaries resident for tax purposes in a tax haven country or jurisdiction within the E.U. (such as Gibraltar or Cyprus) provided that the E.T.V.E. can demonstrate to the Spanish Tax Authorities that the incorporation and operation of the foreign subsidiary in the tax haven is carried out for valid economic reasons and that the foreign subsidiary is engaged in an active trade or business.

eligible to the extent that the nonresident subsidiary possesses sufficient material and human resources to perform such trade or business activity and provided that its clients are not located in Spain.

A nonresident holding company subsidiary will be deemed to be carrying on an active business to the extent that, with respect to its participated nonresident entities, it holds a minimum 5% participation and exercises management and control through proper human and material resources. In addition, the nonresident subsidiaries must qualify as active entities engaged in a trade or business.

A nonresident financial subsidiary will be deemed to be active if it is engaged in financial transactions with individuals or entities resident in its jurisdiction of residence or in a foreign country, other than Spain, to the extent that such financial services are rendered through the material and human resources effectively available to the nonresident financial subsidiary.

iv. Qualified Holding Company

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

- The corporate purpose of the Spanish company includes, among others, the holding of participations in operating nonresident entities;
- The Spanish company carries out its activities with the necessary human and material resources;
- The shares or quotas of the E.T.V.E. are in registered form. Pursuant to a ruling of the Spanish Tax Authorities, Spanish listed companies may opt for the regime; and
- The Spanish holding company informs the Spanish Tax Authorities that it opts to be subject to the provisions of the Spanish holding company regime.

v. Corporate Purpose

The E.T.V.E. may conduct any activities, in Spain or abroad, in addition to holding participations in nonresident companies. However, such activities will not be covered by the E.T.V.E. regime. Therefore, any profits deriving from those activities will be subject to the general 30% C.I.T. tax rate and the dividends distributed on such profits will be subject to regular Spanish withholding tax.

It is not necessary for the E.T.V.E. to control and manage the activities of the participated companies, but rather the participation itself. The Spanish Tax Authorities have interpreted this requirement very flexibly.

vi. Material and Human Resources

This requirement is closely related to the previous one.

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

The D.G.T. takes the view that the proper human and material resources requirement is met, *inter alia*, if the day-to-day management of the E.T.V.E. is vested in one or more directors of the company empowered with sufficiently broad powers of attorney to allow him/her to manage the E.T.V.E., provided that such a director is resident in Spain for tax purposes. Day-to-day activities include the performance of accounting, tax and legal obligations required for the fulfillment of the corporate purpose of the E.T.V.E. Conversely, the D.G.T. has expressly stated that if those services are completely outsourced, it will be deemed that the company does not fulfill the "human and material resources" requirement.

It is not necessary for the E.T.V.E. to control and manage the activities of the participated companies. All that is required is the control and management of the participation.

Finally, it should be noted that all D.G.T. rulings are framed within the context of the E.U. Code of Conduct and the attempt by the Ecofin Council to eliminate harmful tax competition within the E.U.; moreover, certain resolutions of courts in other European countries – such as the Judgment of the Tax Court of Cologne of June 22, 2001 – interpret substance in a similar fashion.

vii. <u>Filing with the Spanish Tax Authorities</u>

The E.T.V.E. must notify the Spanish Tax Authorities of its intention to apply the holding company tax regime. In addition, the Spanish holding company may file ruling requests on the interpretation of the regulations and requirements of the regime. The special tax regime will come into effect with the fiscal period of the E.T.V.E. that ends after the notice is filed.

viii. <u>Deduction of Costs</u>

The value of a participation in the nonresident subsidiaries may be recorded for accounting and tax purposes under the general C.I.T. rules applicable to all Spanish resident companies. Financing expenses connected with the participation are tax deductible within the new limits on deductibility of financial expenses set forth by the Spanish Government in March 2012, as explained in Paragraph F of this chapter, below. Foreign exchange gains and losses are taxable or deductible.

ix. <u>Deduction of Goodwill on Foreign Subsidiaries</u>

If an E.T.V.E. acquires a participation in a nonresident entity, which meets the requirements of the participation exemption regime, the difference between the acquisition cost of the shares and the underlying book value of the foreign subsidiary is attributed to the assets of the foreign subsidiary in accordance with the Spanish accounting valuation rules governing consolidated financial statements (*i.e.*, limited to the market value of the assets). Any difference not allocated

to the step-up of the assets of the target is deductible in 20 years (up to 5%[38] per year) for the E.T.V.E. and may be used to offset taxable profits of the E.T.V.E. (*i.e.,* those profits not linked to its participations in foreign subsidiaries).

However, this tax deductible allowance has been found by the E.U. Commission to represent illegal state aid in the context of an investment in a corporation, either resident or nonresident in an E.U. member state, with certain exceptions, such as China, India and other jurisdictions, where it can be confirmed that legal barriers to cross-border mergers exist.

After the decisions of the E.U. Commission, the goodwill arising from the acquisition of new foreign subsidiaries will not be tax deductible.

C. Liquidation Losses

A loss realized upon the liquidation of a foreign subsidiary is deductible.

D. Exemption of E.T.V.E. Dividend Distributions

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

Otherwise, dividends distributed by the E.T.V.E. will be subject to the standard 21% withholding tax or the reduced bilateral Tax Treaty rate, as applicable. In the context of an E.U. resident shareholder, dividends paid by the E.T.V.E. to its E.U. resident shareholder will not be subject to the dividend withholding tax if the E.U. shareholder:

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

[38] 1% for fiscal years 2013 and 2014.

E. Capital Gains on Transfer of E.T.V.E.

Capital gains triggered by the nonresident shareholders, other than a tax haven company, on the (i) transfer or full amortization of its interest in the Spanish holding company or (ii) liquidation of the Spanish holding company will not be subject to the Spanish Capital Gains tax to the extent that the capital gain is equivalent to (a) the existing reserves (from qualified exempt income) of the Spanish holding company, and/or (b) a difference in value of the interest in the foreign subsidiaries of the Spanish holding company, if such interest fulfills the requirements described above during the whole holding period.

The capital gains exemption represents a substantial improvement to the E.T.V.E. tax regime since capital gains are normally subject to a 21% tax. Although in a tax treaty context, a capital gain on the disposition of shares in the E.T.V.E. will generally not be subject to Spanish taxation, some tax treaties entered into by Spain, such as the tax treaty with the U.S.,[39] allows Spain the right to tax the capital gain at the general 21% tax rate provided that the foreign shareholder has a substantial interest, usually more than 25% of the capital, in the Spanish entity.

In addition, E.U. resident shareholders will not be subject to tax on the capital gain triggered by the disposition of the interest in the E.T.V.E. provided that at no time during the 12-month period prior to the disposition of such interest, the E.U. resident shareholder held a participation in the capital of the E.T.V.E. equal to or greater than 25%.

F. Liquidation of an E.T.V.E.

The liquidation of an E.T.V.E. triggers a capital gain, not subject to withholding tax, taxable as described in Paragraph D of this chapter, above.

G. Other Income Tax Issues

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

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[39] On January 14, 2013, the U.S. and Spain signed a new protocol amending the current 1990 tax treaty for the avoidance of double taxation. This new protocol includes significant changes to foster the efficiency of reciprocal direct investment in the U.S. and Spain. In particular, it brings withholding treaty rates and other provisions in line with the tax treaties in force between the U.S. and the most significant European Union countries, effectively eliminating the need for complex and costly investment planning structuring.

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

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

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

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

H. Corporate Income Tax

i. Rate

An E.T.V.E. is subject to the 30% Spanish corporate income tax on income other than qualified dividends and capital gains, as explained above.

ii. Interest Barrier Rule

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

iii. Capital Duty

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

In addition, certain corporate reorganizations are not subject to capital duty if specified 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.

iv. Transfer Pricing

According to the Spanish C.I.T. Law, Spanish companies are obliged to assess transactions with related parties (those defined in article 16.3 of the C.I.T. Law) on an arm's length basis. In order

to determine the fair market value of the transaction, and following the O.E.C.D. guidelines, the law sets forth that the parties will use any of the following methods: the comparable uncontrolled price method, the cost plus method, the resale price method, the profit split method or the transactional net margin method, the first three being preferential in use.

Additionally, the parties will have to produce and keep appropriate documentation in order to evidence to the Spanish Tax Authorities, as the case may be, the valuation used. This obligation would not be applicable for certain entities and transactions that fulfill some requirements.

The Tax Authorities could impose penalties in two different situations. The first is that the taxpayer does not comply with the above-mentioned documentation obligations. The second is when the taxpayer complies with the documentation obligations but the value of the transaction used by the taxpayer is not the one resulting from the documentation provided to the Authorities. Thus, if the valuation used in transactions with related parties is in accordance with the documentation provided to the Authorities, even if the Tax Authorities disagree with the resulting valuation, the Tax Authorities will not be entitled to impose penalties.

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

The Regulations detail the procedure for resolving the proposals that related parties can submit to the tax authorities.

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

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

Spanish tax authorities are encouraging taxpayers to submit advance pricing proposals and, although it must be said that, unlike in other jurisdictions, taxpayers and tax authorities are not used to deal on preliminary agreements, the tax authorities seem to be very willing and flexible on their stance.

v. Controlled Foreign Corporation

The E.T.V.E., as any other Spanish resident company, is subject to C.F.C. rules, the *Transparencia Fiscal Internacional*. Under the C.F.C. rules, certain income generated by a foreign entity can give rise to C.I.T. for the E.T.V.E. where (i) the E.T.V.E. has a minimum 50% participation in the entity's capital, equity, P&L or voting rights, (ii) such income is tainted income (such as financial income, passive real estate income, and the like), and (iii) the income is subject to a tax lower than 75% of the Spanish C.I.T. that would have been payable.

The E.T.V.E. is not required to recognize tainted income obtained by its E.U. affiliates to the extent that the E.T.V.E. can demonstrate to the Spanish Tax Authorities that the incorporation

and operative of the E.U. affiliate is carried out for valid economic reasons and that the E.U. affiliate is engaged in an active trade or business.

8. IRELAND

The focus of Ireland's tax incentives has been to attract job creation activities. Typically the incentives were in the manufacturing/financial services sectors but they have now been extended to all trading activity. The rate of corporation tax on trading income is 12½% where the trade is controlled or partly controlled from Ireland.

To compliment this low rate, the Irish Government adopted policies to make Ireland an attractive holding company location.

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

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

Irish tax policy for attracting jobs through favorable tax rules may be affected by the O.E.C.D. report on base erosion and profits shifting ("B.E.P.S."), discussed in the introduction. The B.E.P.S. report identifies six key problem areas contributing to the growth of inappropriate profit shifting, including intra-group financial transactions, harmful tax regimes, and digital goods and services. To address these areas the report proposes developing an action plan involving the O.E.C.D. and international tax authority stakeholders. Ireland already has many of the provisions being considered, such as a General Anti-Avoidance Rule, domestic provisions limiting tax relief on intra-group debt, transfer pricing legislation and provisions taxing dividends from non-trading foreign subsidiaries at a higher rate of corporation tax than the headline 12.5% rate. It is envisaged that Ireland will work with its international partners on the action plan and the Irish government will be monitoring the progress of the discussions and envisaged solutions.

A. Corporate Tax Rate

The Irish rate of corporate tax on trading income is 12½%. 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 on Irish courts but is of persuasive value depending on the seniority of the U.K. court. Broadly speaking, it is unlikely that the income of a pure

holding company would qualify as "trading" income. It is more likely to be characterized as passive income as it will be dividends, interest and royalties from its subsidiaries.

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

B. Dividends Received by Irish Companies

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

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

Foreign dividends are subject to Irish tax at the rate of either 12½% or 25%.

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

- That are resident in an E.U. Member State or a country which has a tax treaty with Ireland, or a country which has ratified the O.E.C.D. Mutual Assistance Directive; or

- Whose shares, or the shares of its 75% parent, are substantially and regularly traded on a stock exchange in an E.U. Member State, or a country which has a tax treaty with Ireland, or a country which has ratified the O.E.C.D. Mutual Assistance Directive.

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

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

C. Dividends Paid by Irish Holding Companies

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

The Irish legislation implementing the E.U. parent-subsidiary directive allows an Irish company to make distributions free of withholding tax to E.U. tax resident companies, which comply with the conditions of the directive (*i.e.*, be a certain type of E.U. member state company and pay tax in an E.U. member state) and hold at least 5% of the share capital of the Irish company. No documentary requirements are needed in order for this exemption to apply.

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

- A person, not being a company, who is neither resident nor ordinarily resident in Ireland and who is, by virtue of the law of an E.U. member state or of a country with which Ireland has a double tax treaty, resident for tax purposes in that country;

- A company which is resident in an E.U. member state (other than Ireland) or in a country with which Ireland has a double tax treaty, and which is not under the direct or indirect control of a person or persons resident in Ireland;

- A company which is not resident in Ireland which is under the direct or indirect control of a person or persons who is resident in an E.U. member state (other than Ireland) or in a country with which Ireland has a double tax treaty, provided that controlling person or persons is not itself or are not themselves controlled by a person or persons who is or are not resident in an E.U. member state (other than Ireland) or a country with which Ireland has a double tax treaty. In other words, a company which is not resident in Ireland and which is under the ultimate control of a person or persons resident in an E.U. or treaty partner country.

There is no requirement for nonresident companies receiving dividends from Irish resident companies to provide tax residence and/or auditor certificates in order to obtain exemption from dividend withholding tax. Instead a self-assessment system now applies under which a nonresident company provides a declaration and certain information to the dividend paying company or intermediary to claim exemption from dividend withholding tax. The declaration

extends for a period of up to six years, after which a new declaration must be provided for the dividend withholding tax exemption to apply.

D. Exemption from Capital Gains Tax on Sale of Foreign Shares

An Irish tax resident company will be exempt from Irish corporate tax on its chargeable gains on disposal of shares, or assets related to shares, in certain subsidiaries. The current rate of tax is 30% on the disposal in the event that the exemption does not apply. However, an exemption from the tax is given where there is a disposal of shares (and assets related to such shares) in foreign companies and:

- At the time of the disposal the foreign company is resident for tax purposes in the E.U. or a treaty country (Ireland has signed double taxation treaties with 69 countries, of which 64 are currently in effect);

- The company making the disposal must be beneficially entitled, directly or indirectly to at least 5% of the company's ordinary share capital, at least 5% of the profits available for distribution to the shareholders of the company, and would be beneficially entitled on a winding up to at least 5% of the assets of the company available for distribution to shareholders;

- The disposal must occur during an uninterrupted period of 12 months during which the Irish company, directly or indirectly, holds at least 5% of the ordinary share capital of the company, is beneficially entitled to at least 5% of the profits available for distribution to the shareholders and would be beneficially entitled on a winding up to at least 5% of the assets of the company available for distribution to the shareholders of the subsidiary whose shares are being disposed of or within 24 months of the last such uninterrupted period;

- At the time of disposal of the shares in the investee company (*i.e.*, the foreign subsidiary), either the investee company must carry on a trade or the business of the investor company (*i.e.*, the Irish holding company), its subsidiaries, the investee company and its subsidiaries taken as a whole consist wholly or mainly of trading; and

- The exemption does not apply to the disposal of shares deriving the greater part of their value from Irish land or buildings and certain other Irish assets.

E. Financing the Irish Holding Company – Interest Payment Deductions

Ireland does not have thin capitalization rules. Therefore, an Irish holding company can be financed principally by way of debt. An Irish tax deduction is potentially available for interest on monies borrowed to finance the acquisition of shares. Interest is allowed as a deduction, if it is used in acquiring any part of the ordinary share capital of a trading company, a company whose income consist mainly of real estate rental income, or a holding company of such a trading or real estate rental company. A deduction is also allowed for interest on funds used to

lend to such companies which is used wholly and exclusively for the purposes of the borrower's trade or business or that of a company connected with it.

Certain conditions must be met in order for the interest deduction to be allowed. When the interest is paid, the Irish holding company must beneficially own, or be able to control, directly or indirectly, more than 5% of the company whose shares are being acquired, or to whom the funds are being lent, or a company connected to it. During the period of application of the loan proceeds, until the interest is paid, at least one director of the Irish holding company must be a director of such a company. The Irish holding company must also show that during the application of the loan until the payment of the interest, it has not recovered any capital from such a company, apart from amounts which 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, so as to jeopardize the deduction. In addition, anti-avoidance measures restrict the deductibility of interest where (i) intra-group borrowings are used to finance the acquisition of group assets and (ii) relief is claimed by way of an interest expense deduction on a borrowing to fund activities of related foreign companies. In such circumstances, the interest expense deduction may be denied where the relevant foreign income generated by the use of the loan proceeds is not remitted to Ireland.

Interest paid by an Irish company to a non-Irish resident 75% parent can be recharacterized as a non-deductible 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. Double Tax Treaty, a non-discrimination article in the treaty should override the Irish domestic recharacterization. In addition, an Irish company can elect to have the interest not treated as a distribution provided (i) the company is a trading company, (ii) the payment is a distribution only because it is payable to a non-resident company of which the Irish company is a 75% subsidiary or associate, (iii) it is payable in the ordinary course of the Irish company's trade and (iv) the payment would not otherwise be deductible.

F. <u>Financing of the Irish Holding Company – Interest Withholding Tax</u>

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 non-Irish resident is subject to interest withholding tax, currently at the rate of 20%. However, there are numerous exemptions from the domestic withholding tax on payments of interest. Apart from the relief provided by the relevant treaty, an exemption exists under domestic law. Interest paid by an Irish holding company to a company that is resident in an E.U. member state or a treaty country (*i.e.*, a relevant territory) is exempt from the withholding tax (provided the relevant territory imposes a tax that generally applies to interest receivable in the relevant territory by companies from sources outside it) except where the interest is paid to such a company in connection with a trade or business carried on in Ireland.

G. Treaty Network

Ireland has signed double taxation agreements with 62 countries of which 55 (listed below) are currently in effect.

Albania
Armenia
Australia
Austria
Bahrain
Belarus
Belgium
Bosnia & Herzegovina
Bulgaria
Canada
Chile
China
Croatia
Cyprus
Czech Republic
Denmark
Estonia
Finland
France
Georgia
Germany
Greece
Honk Kong
Hungary
Iceland
India
Israel
Italy
Japan
Republic of Korea
Latvia
Lithuania
Luxembourg
Macedonia
Malaysia
Malta
Mexico
Moldova
Montenegro
Morocco
Netherlands
New Zealand
Norway
Pakistan
Panama
Poland
Portugal
Romania
Russia
Saudi Arabia
Serbia
Singapore
Slovak Republic
Slovenia
South Africa
Spain
Sweden
Switzerland
The Republic of Turkey
United Arab Emirates
United Kingdom
United States
Vietnam
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. Importantly, Irish domestic law grants a tax treatment more favorable than that given by the treaties. (See Paragraph D above, in connection with tax credits for foreign dividends.)

H. Capital Duty

Companies Capital Duty is no longer imposed on share capital and certain other transactions.

I. Stamp Duty on Shares

Stamp duty of 1% of the value is imposed on the transfer of shares in an Irish company. This duty is a cost, where the Irish holding company is the ultimate company. On the other hand,

where the Irish company is an intermediate holding company in the group, much can be done through exemptions and tax planning to claim relief from or to avoid the duty. The exemptions comprise the associated companies' relief and the reconstruction and amalgamation provisions that apply in group reorganizations.

J. 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 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).

K. Thin Capitalization/Transfer Pricing/C.F.C. Rates

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

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

L. Relevant Anti-Avoidance Provisions

Ireland does not have relevant anti-avoidance provisions.

M. Conclusion

Ireland has considerable tax efficiency as a location for a holding company in an E.U. treaty country dimension. Generally, the negative factors disappear when Ireland is used as the jurisdiction for an intermediary holding company. The greatest tax benefit can be obtained when head office activity is carried out by the Irish company, in addition to its holding company role.

9. UNITED KINGDOM

A. Introduction

The summary of U.K. law is correct as at 24 May 2013.

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.

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

Non-domiciled individuals who have been resident in the U.K. for substantial periods of time must pay a charge to continue using the remittance basis:

- Non-domiciled individuals who have been resident in the U.K. for 12 of the last 14 tax years must pay a £50,000 annual charge; and

- Non-domiciled individuals who have not met the 12 year test but who have been resident in the U.K. for 7 of the last 9 years must pay a £30,000 annual charge.

The £50,000 charge was introduced with effect from April 6, 2012 by the Finance Act 2012. The U.K. Finance Act 2012 also includes measures intended to encourage non-domiciled individuals to invest in the U.K. and where they apply, the individual will not be treated as having remitted the income to the U.K. provided that an appropriate claim is made. The "relief" is not available if the remittance is part of a scheme or arrangement to avoid tax. Care must be taken as it is possible that funds brought into the U.K. under these rules may still be treated as remitted to the U.K. and therefore within the U.K. tax net.

The U.K. introduced, with effect from April 6, 2013, a statutory tax residence test which, at least in theory, is intended to provide certainty to foreign executives about their U.K. tax position. Individuals should note that their U.K. tax residency status under the statutory residence test may differ from treatment in prior years.

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

- Competitive corporation tax rates. As at the date of writing, the main rate of U.K. corporation tax is 23%. On April 1, 2014, it will go down to 21% and on 1 April 2015, it will be further reduced to 20%. As a result, from April 1, 2015, the main rate of corporation tax, the basic rate of income tax and the standard V.A.T. rate will, it is expected, all be 20%;

- Exemption from corporation tax for most dividends received from U.K. and foreign resident companies, backed up by a foreign tax credit system where the exemption does not apply, which permits (within limits) pooling of foreign source dividends to maximize foreign tax credit;

- No withholding tax on dividends paid by U.K. companies to nonresident shareholders (except in the case of R.E.I.T.s);

- Exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups;

- Optional exemption for foreign branch profits;

- No capital gains tax generally on the sale of shares in U.K. companies by nonresidents. It is now also possible, in some circumstances, to structure asset sales in a tax-effective way in order to obtain the protection of the substantial shareholding exemption;

- No capital taxes on formation or paid-in capital of companies;

- The U.K. has introduced an optional "patent box" regime as part of its strategy to incentivize innovation and the development and retention of certain intellectual property rights in the U.K. Broadly, under the patent box regime, the worldwide profits from the exploitation of eligible patents or other qualifying rights held by qualifying companies will ultimately be subject to a lower U.K. corporation tax rate of 10%. The rules for implementation of the patent box regime came into force on April 1, 2013, although the full benefit of them (that is, taxation of relevant, qualifying profits at 10%) will not be available until 2017. Taxpayers must elect into the new regime.

- Introduction of new "above the line" research and development ("R&D") tax credit for qualifying companies that incur qualifying expenditure on or after April 1, 2013. Until March 31, 2016, companies will be able to choose between the so-called "super deduction" regime (under which "large" companies can claim a tax deduction of 130% of qualifying expenditure and "small and medium size companies and enterprises" can claim a deduction of 225% of qualifying expenditure) and the new "above the line" credit system. After that date, the "above the line" credit regime will be compulsory. Under the new regime, eligible companies (including those with no corporation tax liability, such as those in losses) will be paid a taxable credit to the value of 10% of their qualifying R&D expenditure;

- The U.K. now has a more sensible controlled foreign company ("C.F.C.") regime which is narrower in scope than the old regime;

- One of the most extensive tax treaty networks in the world; and

- The U.K. has also confirmed that it will not introduce a financial transactions tax ("F.T.T.") unless introduced on a global basis and has in fact sought to challenge the introduction of the F.T.T. proposed by eleven member states including France and Germany.

Many of the recent material changes to the U.K. tax system are part of the drive to make the U.K. more competitive and "business friendly". As well as these statutory changes, there have also been a number of noteworthy decisions handed down by the European Court of Justice ("E.C.J.") and the U.K. courts, including the Franked Investment Income/Foreign Dividend Group Litigation (Case C-446/04) (see Paragraph C below) and the Thin Cap Group Litigation (Case C-524/04), which have had a major impact on the U.K tax rules.

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

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

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

On a similar point, in *F.C.E Bank* (see Paragraph P below) it was held that the old U.K. group relief rules which prevented a claim for group relief between two U.K. subsidiaries both owned by a U.S. parent contravened the non-discrimination article in the 1975 U.S./U.K. double tax agreement.

Finance Act 2011 amended the U.K. rules to (a) remove the requirement that the link company be subject to the U.K. corporation tax regime and will open the relief to any qualifying E.E.A company and (b) cap ability to claim the relief by a test based on the level of control/proportion of voting rights held in the loss vehicle.

B. <u>Corporate Tax Rate</u>

As stated above, the main rate of U.K. corporation tax is 23%. On April 1, 2014, it will go down to 21% and on April 1, 2015, it will be further reduced to 20%.

This is levied on the worldwide income and gains of U.K. resident companies. Capital gains derived by U.K. companies are taxed generally at the same rate as income. However, the base cost of assets is indexed by reference to the U.K. retail price index to eliminate gains based on inflation, although indexation relief does not apply to the high value residential property charge).

The rate of tax of 20% exists for companies whose profits do not exceed £300,000. Between those rates, marginal rates are applied, so that companies earning in excess of the relevant thresholds (currently £1.5 million) have all of their income taxed at the higher applicable rate.

Computation of profits for corporation tax purposes generally follows U.K. G.A.A.P. or International Accounting Standards in the case of companies whose shares are listed on an exchange in the E.U. As a result of successive reforms, specific codes apply accounting

principles to profits on loan relationships (interest), foreign exchange gains and losses, derivative contracts, and intellectual property rights and other intangibles.

C. Dividends Received By U.K. Companies

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

The exempt classes are:

- Distributions from controlled companies;
- Distributions in respect of non-redeemable ordinary shares;
- Distributions in respect of portfolio holdings, which are holdings of less than 10%;
- Dividends derived from transactions not designed to reduce tax;
- Dividends in respect of shares accounted for as liabilities under G.A.A.P. but which are not treated as debt for tax purposes because they are held for non-business or tax avoidance purposes;
- Some capital distributions. Distributions made out of reserves arising from a reduction in capital are distributions for the purposes of the exemption. Those distributions that are capital in nature and which fall outside of the "dividend exemption" may be subject to corporation tax on chargeable gains unless the substantial shareholding exemption or another exemption or relief is available.

Each has anti-avoidance measures designed to prevent manipulation of the exemptions. In addition, other anti-avoidance rules (including the new general anti abuse rule – as to which see Paragraph R) may preclude a taxpayer from claiming the exemptions in cases of schemes in the nature of loan relationships where the return is the economic equivalent of interest, schemes involving payments for distributions or payments not on arm's length terms as well as schemes involving diversion of trade income.

D. Foreign Tax Credit

Where the exemptions described above do not apply, or where the U.K. corporate shareholder elects out of the exemption, the general rule is that a credit is granted against U.K. corporation tax for foreign withholding tax levied on dividends. In addition, indirect foreign tax credit

(referred to in the U.K. as "underlying credit tax") is granted in respect of dividends paid by nonresident companies where the U.K. company has a substantial interest in the foreign company. The threshold is, in most cases, determined by treaty. The usual requirement is that the recipient company must own shares that represent at least 10% of the voting power in the paying company. Provided that the dividend payer and the recipient are related, underlying tax in this context includes underlying tax from related companies through an indefinite number of successive levels in the corporate chain. For this purpose, two corporations are related where the shareholder receiving the dividend directly or indirectly controls not less than 10% of the voting power in the paying company. Alternatively, the shareholder may be a subsidiary of a company that controls the dividend-paying company under the foregoing standard.

i. 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.

ii. Mixer Companies and Pooling

In order to blend income from different foreign affiliates taxed in foreign jurisdictions at varying tax rates, it was previously common to hold foreign subsidiaries through a nonresident "mixer" company. This effected a blending of foreign income and underlying tax to be credited against all dividends paid by the mixer to the U.K. parent company. Such mixers were typically located in the Netherlands or Luxembourg.

The current tax regime eliminates the utility of an offshore mixer, and indeed, provides some disincentives to holding foreign companies through a chain of subsidiaries in respect of dividends paid by other foreign companies. Mixing of dividends outside the U.K. is eliminated by capping the credit for foreign tax at a rate equal to the main U.K. rate at each level in the corporate chain.

Offshore mixing has, however, been replaced with onshore pooling of foreign tax credits. The use of pooling eliminates the need to have a two-tier structure involving offshore mixer companies. The current rules relating to foreign tax credits allow excess foreign tax from one source (*i.e.,* one foreign company) to be applied against foreign tax in respect of dividends paid by other foreign companies. Foreign tax in excess of the main U.K. rate (eligible unrelieved foreign tax or "E.U.F.T.") is available to be credited against U.K. tax on dividends from foreign sources. E.U.F.T. may also be surrendered between members of a U.K. tax group to the extent that it is not used within the company in receipt of dividends. Unused E.U.F.T. may be carried back three years and carried forward indefinitely. This pooling is not unlimited. First, there is no credit to the extent that the foreign tax on non-U.K. dividend income exceeds 45%. Second, it cannot be offset against tax in respect of a dividend which itself gives rise to E.U.F.T. Since E.U.F.T. may be generated at any level in the foreign corporate chain, this imposes a positive disincentive to hold foreign affiliates through intermediate holding companies.

iii. Anti-Avoidance

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

The legislation applies where four conditions are satisfied:

- Foreign tax is allowable as a credit against U.K. tax under any arrangements;
- There is a scheme or arrangement, the main purpose, or one of the main purposes of which, is to cause an amount of foreign tax to be taken into account;
- The scheme or arrangement is prescribed;
- 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 a minimal.

Schemes or arrangements are prescribed by §§ 83-88 T.I.O.P.A. 2010. They are briefly where:

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

Where these criteria are met, H.M.R.C. will issue a notice directing the application of the legislation (§§ 81(1), (2), and 82(2) T.I.O.P.A. 2010. Taxpayers are then required to form a view on how the legislation should apply and self-assess or amend any existing self-assessment in the normal way (§§91-95 T.I.O.P.A. 2010). Disputes on the application of the rules will be resolved through the self-assessment enquiry and appeals procedure. Where the legislation is invoked, the credit claim will be limited so as to cancel the effect of the scheme or arrangement (§ 90 T.I.O.P.A. 2010).

The rules are elaborated where underlying tax of nonresident companies is involved. In that case, the counteraction will apply where, had the nonresident company that paid the foreign tax been U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company (§ 81 T.I.O.P.A. 2010).

It is worth noting that the U.K. general anti-abuse rule ("G.A.A.R.") will apply in addition to the anti-avoidance rules set out here.

iv. Hybrid Instruments

Where certain payments may be characterized as a dividend for U.K. tax purposes, but as interest payments in another jurisdiction, the foreign payer would obtain a tax deduction for foreign tax purposes, while a U.K. corporate recipient otherwise meeting the requirements of §§ 12-16 T.I.O.P.A. 2010, or treaties providing similar treatment (such as the U.S.-U.K. Income Tax Treaty) obtains credit for underlying tax in respect of the receipt. Credit for underlying tax will not be given if a tax deduction is given in another jurisdiction, calculated by reference to the amount treated as a dividend for U.K. purposes (§ 57(3) T.I.O.P.A. 2010). The denial of credit for foreign tax is automatic and not limited to instruments created or assigned for the purpose of obtaining the benefit of the credit.

E. Dividends Paid By U.K. Companies to U.S. Shareholders

The U.K. does not impose withholding tax on dividends. Withholding tax at the rate of 20% applies to dividends paid by U.K. resident Real Estate Investment Trusts ("R.E.I.T.s"). This may be reduced by applicable tax treaty. Since a company cannot qualify as a R.E.I.T. if it has shareholders with a 10% or greater participation, only the rate on portfolio holdings will apply. The rate is 15% under the current U.S.-U.K. Income Tax Treaty for qualified U.S. residents.

F. Capital Gains Tax Exemption on the Disposal of Operating Company Shares

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

G. Substantial Shareholding

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

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

By way of background, the U.K. imposes a tax charge if a company leaves a group within 6 years of certain events happening such as an asset transfer. The de-grouping gain (or loss) would have ordinarily been triggered in the departing company. However, from April 1, 2011, these de-grouping gains/losses will fall to be taxed in the hands of the transferor company and the gains (or losses) will be added to or subtracted from the consideration received by the transferor for its disposal of its shares in the transferee. In consequence, no de-grouping charge should arise if the disposal qualifies for the S.S.E., although a tax charge will still arise if the de-grouping is otherwise than on a share disposal, *e.g.*, the issue of new shares.

Coupled with other changes, it is now possible to structure a trading business sale in the U.K. without giving rise to a chargeable gain by hiving down the business to a newly set up subsidiary and selling that subsidiary under the protection of the S.S.E.

H. Trading Company Limitations

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

A trading group means a group in which one or more members carry on trading activity. In addition, the activity of the group members, when taken together, must not include "to a substantial extent" activities other than trading activities. "Trading company" and "trading sub-group" are defined in a similar manner. H.M.R.C. has indicated that it will interpret this as meaning that 80% of the value of the group must be attributable to trading activity.

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

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

Any gain or loss that would have arisen under the foreign exchange matching rules, connected with a disposal of a substantial shareholding, will no longer be a chargeable gain or capital loss.

This is a logical extension of the exemption in relation to foreign shareholdings where the currency exposure has been hedged.

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

I. Capital Gains on the Disposal by Nonresidents of Shares in U.K. Companies

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

J. Capital Tax and Stamp Duty

There is no capital tax on the formation of a company or on any capital paid in. No stamp duty is paid on share subscriptions. Transfers of shares of U.K. companies are liable to stamp duty or stamp duty reserve tax ("S.D.R.T") at 0.5% of the consideration for the sale. This may be increased to 1.5% where incorporated companies are issued or transferred into a clearing system or a depository receipt facility. Although the recent decision of the First Tier Tribunal in *HSBC Holdings and Bank of New York Mellon Corporation v The Commissioners for H.M.R.C.* [2012] U.K.F.T.T. 163 (T.C.) confirmed that the U.K. S.D.R.T charge of 1.5% levied on the issue of depositary receipts (including American Depositary receipts, "A.D.R's") infringed E.U. law if the imposition is in connection with the raising of capital by an E.U. company, even if the depositary happens to outside the E.U. In consequence, the 1.5% S.D.R.T charge will no longer be levied on issues of U.K. shares or securities to depositary receipt issuers and clearance services anywhere in the world. Going forward, the 1.5% S.D.R.T charge will only apply to transfers (on sale or otherwise on sale) of shares and securities to depositary receipt systems or clearance services that are not an integral part of the issue of share capital. H.M.R.C. has confirmed that it will not appeal the *HSBC* decision.

As noted above, the U.K. does not propose to introduce the European F.T.T. into domestic law.

K. Tax Treaty Network

The U.K. has in effect treaties with at least 100 jurisdictions. The significance of the extensive U.K. treaty network is in reducing or eliminating non-U.K. taxes on payments made to recipients that are resident in the U.K. The U.K. treaty negotiating position is to seek to eliminate withholding taxes on interest and royalties. About one quarter of the U.K. treaties achieve this, with others typically reducing the rates. Almost all treaties reduce foreign withholding taxes on dividends. In the case of dividends paid by subsidiaries in other E.U. member states, the European Parent/Subsidiary Directive eliminates withholding tax. A 10% minimum holding is required to qualify under the Directive. U.K. treaties commonly exempt the disposal of shares

from capital gains tax in the source state. Intragroup interest and royalty payments may also be free of withholding tax when paid to an associated company in another E.U. member state pursuant to the European Interests and Royalties Directive.

L. Debt Financing of U.K. Companies

The U.K. has liberal rules in connection with the deduction of interest expense. Most interest expense and other costs of debt finance are deductible. Deductibility is determined , depending on the circumstances, on either the fair value or amortized cost basis (§ 349 C.T.A. 2009). Related party financing must be in accordance with the accruals method. These rules apply in relation to "loan relationships." Loan relationships are broadly defined and exist in respect of a money debt that arose from a transaction for the lending of money. This is the case where a company 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.

Anti-avoidance provisions (see § 441 C.T.A. 2009) permit the disallowance of interest expense where the interest or loan relationship has tax avoidance as its purpose, or as one of its main purposes. Although the legislation is widely drawn, it is generally regarded as applying in limited circumstances. In particular, recent discussions relating to interest expense incurred in order to acquire shareholdings that qualify for exemption from corporation tax under the new S.S.E. described above will likely be permitted. Likewise, borrowing which is connected with the purchase of shares in respect of which foreign tax credits eliminate the U.K. tax liability are normally regarded as not contravening these rules. Other anti-avoidance provisions also aimed at denying interest expense deductions have relatively limited application.

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

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

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

Most U.K. source interest is subject to withholding tax at the rate of 20%. Exclusions apply for "short" interest that is interest on debt with a term of less than one year. Interest on "quoted Eurobonds" may also be paid without deducting tax at source. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized Stock Exchange. The U.K. government consulted on a number of important changes to the taxation of interest in 2012 (including proposals to repeal the "quoted Eurobond" in relation to group

arrangements and “short” inter withholding tax exclusions and to required tax on a funding bond to be paid to H.M.R.C. in cash).

However, as a result of that consultation process, the only changes proceeded with are broadly as follows:

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

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

- The issuer of a funding bond will be required to issue a certificate indicating its value on issue.

These feature in Schedule 11 to the Finance Bill 2013 and are expected to take effect for most payments of interest made on or after October 1, 2013. The proposed repeal of the "quoted Eurobond" and "short" interest rules and, save for the point above, the changes to the funding bond rules have not been proceeded with.

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

The U.K. G.A.A.R. will apply (amongst other things) to counteract any interest deductions claimed other debt financing arrangements which are in breach of the spirit of the law and underlying policy of the legislation (refer to Paragraph R below).

M. Anti-Arbitrage Legislation

The U.K. statute book contains legislation (see part 6 of T.I.O.P.A. 2010) aimed at countering tax avoidance using arbitrage schemes that involve among others hybrid entities. Where it applies, a deduction for corporation tax purposes will be denied to U.K. companies if, and to the extent that more than one deduction (or an amount otherwise allowed for tax purposes) is available for the same expense whether in the U.K. or elsewhere and the income accruing or arising under the scheme is only taxed once.

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

- The U.K. company must be a party to a scheme that involves among others a hybrid entity (a "qualifying scheme"). For these purposes, a hybrid entity is an entity that is recognized as a taxable person under one tax code (*e.g.*, the U.K.), but whose profits or losses are under of the same or another tax code taxable in the hands of one or more persons other than the entity (*e.g.*, the U.S.). This may be because, for example the two countries treat the same entity differently, one treating it as a company taxable on its own income (the U.K.), and the other seeing it as a partnership with its partners taxable themselves on their shares of its income (*e.g.*, the U.S.). "Scheme" is widely drafted to cover any arrangements or understandings whether or not legally enforceable;

- A deduction is allowed for U.K. corporation tax purposes;

- The main purpose or one of the main purposes in adopting the qualifying scheme was the obtaining of a U.K. "tax advantage." A U.K. tax advantage includes a relief or increased relief from tax, or a deduction in computing profits or gains. This includes the deduction of the interest expense on the loans;

- The amount of the U.K. tax advantage is not minimal (*i.e.*, if it exceeds £50,000 see INTM595080).

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

N. <u>Worldwide Debt Cap</u>

A further restriction of the amount of interest claimed by the U.K. members of a multinational group by reference to the group's total consolidated external finance costs is contained in Part 9A of T.I.O.P.A 2010 and takes effect for accounting periods starting after January 1, 2010. Broadly, the restriction applies to any worldwide group where the U.K. net debt of the group, exceeds 75% of the worldwide gross debt of the group. For this purpose, U.K. net debt of any company less than £3 million is treated as nil.

The total disallowed amount of the worldwide group is the excess of the aggregate relevant financing expense amounts of U.K. resident group companies and permanent establishments of non-U.K. resident members, over equivalent amounts of the worldwide group. In calculating aggregate financing expense, the net financing expense of a company below £500,000 is treated as nil. The disallowed amount may be allocated among relevant companies as determined by the group, but failing proper allocation is apportioned by formula. Where a financing expense disallowance arises, a corresponding exemption applies to financing income of relevant companies. Financing income received may also be exempt if the payer is tax resident of an

E.E.A. territory and is denied relief for payment. Exclusions apply to group treasury companies, oil extraction companies, shipping operations within the tonnage tax and to intra-group short term finance. Qualifying securitization companies are excluded.

O. Controlled Foreign Companies

i. Background

The U.K. controlled foreign companies regime seeks to apportion the profits of a controlled foreign company ("C.F.C.") to certain of its U.K. corporate shareholders. These rules were challenged in the Courts as being contrary to E.C. law in respect of C.F.C.s in E.U. member states. In *Cadbury Schweppes plc v H.M.R.C.* (Case C-196/04), the E.C.J. held that while C.F.C.-type rules contravene Community law in principle, they may be justified in relation to "wholly artificial arrangements designed to circumvent national tax systems" and that establishing a company in a very low tax jurisdiction within the E.U. does not itself constitute such an arrangement. It is for national Courts to determine if such arrangements exist. In *Vodafone 2 v H.M.R.C.* (No2) [2008] E.W.H.C. 1569, the High Court held that the motive test could not be interpreted as being consistent with the E.C.J. ruling. The only permitted anti-avoidance legislation that would be compatible with Article 43 is that which prohibits artificial arrangements solely to avoid tax and where C.F.C. is not established in a member state conducting bona fide commercial operations there. The Court of Appeal ([2009] E.W.C.A. Civ 446) found that the legislation could be read in a way that conforms to the decision of the E.C.J. An application by Vodafone for leave to appeal was refused by the Supreme Court.

ii. Overview of Current Regime

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

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

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

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

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

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

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

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

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

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

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

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

iii. C.F.C. Rules Apply to Profits, not Gains

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

iv. **Taxation of Foreign Branches of U.K. Companies**

Reflecting the rationale behind the move to dividend exemption, 2011Chapter 3A of Part 2 of C.T.A. 2009 contains a broad exemption from U.K. corporation tax for the overseas trading profits, gains and investment income of a permanent establishment (referred to in the legislation as a branch) of most U.K. resident companies.

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

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

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

Like the C.F.C. rules, the regime contains a number of anti-avoidance rules and the new general anti abuse rule (see Paragraph R below) will also apply so specific advice should always be sought.

P. **The U.K. – U.S. Double Tax Treaty**

The U.S. – U.K. double tax treaty has recently been considered by the U.K. courts:

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

In the case of *Bayfine U.K.* v *H.M.R.C.* [2010] E.W.H.C. 609 (Ch), the Court of Appeal held that a U.K. resident taxpayer was not able to claim treaty relief for U.S. tax paid by the U.S. parent on the profits of the U.K. subsidiary. Specifically, the Court held that the U.K. was not obliged to grant relief under the U.S.–U.K. double tax treaty where doing so would be contrary to avoiding the imposition of double tax and minimizing tax avoidance.

In the *F.C.E. Bank* case (*H.M.R.C.* v *F.C.E. Bank plc* [2012] E.W.C.A. Civ 1290), the U.K. Court of Appeal held that the old group relief rules which prevented two U.K. resident (sibling) subsidiaries of a U.S. resident parent company from forming a group for the purposes of surrendering trading losses contravened the non-discrimination article in the U.K./U.S. double

tax treaty (albeit the 1975 U.K./U.S. double taxation treaty). The U.K. taxpayer argued that relief was denied to it in circumstances where it would be available if the parent company were U.K. resident.

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

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

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

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

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

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

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

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

R. <u>General Anti Abuse Rule ("G.A.A.R.")</u>

Finance Bill 2013 contains provisions which will enact a G.A.A.R. in the U.K.

The G.A.A.R. is broadly intended to apply to "arrangements" (including agreements, understandings, transactions whether or not legally enforceable) in respect of most taxes (but not for example V.A.T) pursuant to which obtaining a "tax advantage" was the main or one of the main purposes of entering into that arrangement. For these purposes, a "tax advantage" includes obtaining a relief or an increased relief from tax. If such an arrangement is "abusive", then H.M.R.C. can, if it meets certain procedural requirements, seek to have the arrangement counteracted. Arrangements will be considered to be "abusive" if they are "arrangements the entering into or carrying out of which cannot be reasonably regarded as a reasonable course of action having regard to the circumstances" (clause 204(2) of the Finance Bill 2013). This is referred to as the "double reasonableness test". The circumstances that can be considered when ascertaining whether a transaction is abusive include whether the substantive results of the arrangements are consistent with the underlying policy of the relevant provisions, whether the means of achieving the tax advantage was contrived or abnormal and whether the arrangement exploits any shortcomings in the legislation. The (draft) legislation sets out indications of when a transaction is likely to be abusive and includes cases where the tax position does not reflect the economic reality (for example, an interest expense is larger for tax purposes than what in actuality has been paid). Arrangements that accord with established and acknowledged H.M.R.C. practice will not generally fall foul of the G.A.A.R.

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

The G.A.A.R. will broadly take effect for tax arrangements entered into on or after the date that the Finance Bill 2013 receives Royal Assent (likely to be mid-July 2013) although where a tax arrangement entered into before that date results in a tax advantage arising after the date of Royal Assent, that element may be within scope if the criteria is satisfied.

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

It is not possible to obtain a specific clearance from H.M.R.C. that the G.A.A.R. does not apply although, depending on the transaction type and circumstances generally, other clearances on similar purpose tests may be available.

Guidance on how H.M.R.C. interpret the G.A.A.R. (approved by the Advisory Panel), including worked examples, has been published on H.M.R.C. website (<u>www.hmrc.gov.uk</u>). Amongst other things, it confirms that arrangements which accord with making a straight forward choice, for example, by funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, arrangements which accord with long established practice will also not be subject to the G.A.A.R. unless contrived.

S. Foreign Account Tax Compliance Act ("F.A.T.C.A.") – U.K. implications

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

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

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

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

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

ii. Implementation of the I.G.A.

Further to entering into the I.G.A., on September 18, 2012, H.M.R.C. engaged in consultation on the U.K. implementation of F.A.T.C.A. which culminated in draft primary legislation contained in Finance Bill 2013, draft secondary legislation and draft H.M.R.C. guidance. This primary and secondary legislation is likely to come into force in mid-July together with the rest of the Finance Bill 2013.

iii. The I.G.A. - Implications

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

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

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

If the U.K. holding company is obliged to comply with F.A.T.C.A. as implemented in the U.K., you should seek specific advice as the law remains in a relative state of flux.

10. AUSTRIA

A. Introduction

Austria, unlike other countries as for example Switzerland or Luxembourg, does not recognize a specific holding company status. Therefore, a holding company is taxed in Austria as any other company. Nevertheless, the following features of the Austrian tax system make Austria a favorable jurisdiction for international holding companies:

- International participation exemption for dividends and capital gains received from foreign subsidiaries;
- No thin capitalization legislation;
- A competitive tax rate of 25% ;
- No C.F.C. legislation;
- No withholding tax on interest paid to nonresidents;
- No withholding tax on dividends paid to EC-resident parent companies;
- Extensive network of tax treaties (more than 80 treaties, in particular with all major Austrian trading partners and with Eastern European countries and former member states of the U.S.S.R.), reducing or eliminating the general withholding tax rate of 25% on dividends;
- Possibility to obtain advance tax rulings with regard to reorganization, group taxation, and transfer pricing issues and informal advance tax rulings with regards to other tax questions;
- A group taxation system that allows Austrian holding companies to deduct losses incurred by foreign subsidiaries; and
- Full deductibility of interest expenses for loans in connection with the acquisition of subsidiaries that are not already members of the group.

B. Capitalization of Austrian Companies

i. Equity Contributions

Equity contributions and profit participating loans to an Austrian company are subject to the non-recurrent Capital Tax at a rate of 1%. Equity contributions are only taxable if made by a direct shareholder of the company. Hence, contributions to a second-tier subsidiary by a shareholder of the parent company generally do not give rise to a capital charge. In addition, various exemptions are available, the most important of these being the exemptions available for mergers and other reorganization measures provided by the Capital Tax Act and the Reorganization Tax Act. Careful tax planning should therefore eliminate or reduce the Capital Tax burden on high equity contributions.

ii. Loan Capital

It is noteworthy that Austria does not have a statutory thin capitalization rule. Loan arrangements between an Austrian company and one of its shareholders are generally recognized for tax purposes provided the terms of the loan meet the conditions of an arm's length test and that a third party would grant a loan with regard to the financial situation of the company. If not, the loan capital will be qualified as equity with the result that capital tax of one percent is levied on the contribution and that interest paid on the loan will not be deductible as a business expense but treated as a hidden distribution to the shareholder. In practice, debt/equity ratios of 98:2 are accepted as at arm's length loan arrangements by the tax authorities under certain circumstances.

Profit participating loans will be subject to capital tax at the rate of 1% unless more than 50% of the interest is fixed.

C. Corporate Taxation

i. In General

A company is resident in Austria for tax purposes if it has its legal seat or its effective place of management in Austria. Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 25%. Independent of the taxable income, a minimum tax of 5% of the statutory minimum share capital is levied, *i.e.*, €1,750 for limited liability companies and €3,500 for stock companies. The minimum tax payments can be set off against higher tax burdens in the future without limitation.

A nonresident company is taxable on business income derived in Austria if it carries on a business through a permanent establishment in Austria or participates in such a business. Income and capital gains from Austrian real estate are also taxable as Austrian business income of the nonresident company even if the real estate is not attributable to an Austrian permanent establishment.

A nonresident company is further taxable on certain other items of income from Austrian sources, in particular dividends from Austrian companies (if not exempted under the participation exemptions) or royalties.

ii. Participation Exemption

a. Participation Exemption for Dividends Received from Austrian Corporations and Portfolio Participations in Foreign Corporations

Pursuant to Section 10/1 of the Austrian Corporate Income Taxation Act ("C.T.A.") dividends (or similar distributions of profits) received by an Austrian company from (i) another Austrian company or cooperative or (ii) from comparable entities resident in the European Union, or (iii) comparable entities resident in any other country with which Austria has concluded a comprehensive mutual administrative assistance treaty are tax exempt disregarding the extent or period of holding the participation.

The tax exemption for portfolio-participations in foreign companies is not granted if the foreign entity is not subject to a tax system comparable to Austria, the tax rate is less than 15% or the foreign entity is subject to comprehensive tax exemptions. In these cases, the dividends paid are not tax exempt but foreign tax paid is credited against Austrian tax (switchover).

Capital gains from the sale of an Austrian domestic participation or portfolio participation in a foreign corporation, however, do not fall under the participation exemption and are subject to tax at the standard rate of 25%. Gains realized upon the liquidation of the subsidiary are treated as capital gains and not as dividends with the result that the domestic participation exemption does not apply.

A different set of exemption provisions applies for participations in non-Austrian companies that qualify as international participations. These are discussed below in Paragraph C.ii.b of this chapter.

b. Participation Exemption for Qualifying International Participations

1) Qualifying International Participations

According to Section 10/2 C.T.A., a foreign company (including any company resident in the European Union or in the European Economic Area) is a qualifying international participation if the following conditions are met:

- The Austrian company holds, directly or indirectly through a transparent entity (*e.g.*, partnership), at least 10% of the share capital of the foreign company;
- The shares must have been held for a minimum period of one year; and
- The foreign company is comparable to an Austrian company or meets the requirements of Article 2 of the E.U. Parent/Subsidiary Directive.

2) Tax Exemptions

Qualifying international participations are tax exempt both with regard to dividend payments and capital gains derived from such a participation (Sec 10/1 nr 7 C.T.A.).

The tax exemption for dividends includes dividends and other distributions paid out from profits earned by the foreign company prior to the acquisition of the shares by the Austrian holding company.

3) Capital Gains

Capital gains (or losses) from the alienation of shares and from the liquidation of a foreign company are (generally) tax neutral pursuant to Section 10/3 C.T.A. This system of tax neutrality means that capital gains or losses are disregarded and therefore not included in the tax base. Further, no tax deduction for a write down of the value of the participation may be claimed. However, losses incurred in the course of the termination of the company (voluntary winding-up or insolvency) remain deductible, insofar as they exceed the tax exempt income received during the five business years prior to the commencement of the winding-up or insolvency proceedings.

The system of tax neutrality of capital gains, losses, and write downs does not apply if the Austrian holding company opts for including these items in its tax base. This option must be executed when filing the tax return for that business year during which the qualifying participation has been acquired. The option is irrevocable and extends automatically to other shares in the same company that the Austrian company may acquire later on.

For a change in the tax status by virtue of a subsidiary's transfer of domicile, the following provisions apply. Should a subsidiary become an "international participation" through the transfer of the Austrian subsidiary's seat to a foreign country, the difference between the book value of the participation and its higher going-concern-value at the time of the transfer remains taxable in case of a later sale of the participation. On the other hand, if a foreign subsidiary loses its "international participation" status by virtue of the transfer of its seat to Austria (and provided further that no election for the taxation of the capital gains and losses as described above has been made), the higher going-concern value at the time of the transfer is deemed to be the book value for the purpose of computing capital gains and losses.

This provides for tax planning opportunities. If it is expected that the value of a participation in an Austrian subsidiary will rise in the future it may be advisable to transfer the seat of the subsidiary to a foreign jurisdiction; the difference between the going-concern value at the time of the transfer and the later sales price would then be tax free. Conversely, a foreign subsidiary, for which no election to tax has been made, could be transferred to Austria if it is expected that its value will decrease in future with the result that a capital loss becomes deductible.

4) Anti-avoidance Provisions

The tax exemption for international participations is not available under specific anti-avoidance provisions:

- The main business of the company consists in, directly or indirectly, deriving interest income, rental income from movable tangible property (*i.e.*, rents from immovable property are not detrimental) or income from royalties or the

alienation of participations (passive income). Dividend income derived (directly or indirectly) from operating companies is not considered as passive income.

- The foreign taxation of the company is not comparable to the Austrian system of corporation taxation. According to the International participation ordinance of the Minister of Finance a foreign tax system is comparable to the Austrian system if the average tax rate of the foreign company computed in accordance with the principles of Austrian tax law exceeds 15%. Foreign taxes that are indirectly imposed on the income of the foreign company are taken into account when calculating the foreign average tax rate. If the 15% threshold is missed only because the foreign tax law allows a deduction of depreciations on fixed assets or a deduction of losses carried forward which would not be deductible under Austrian law, the foreign corporate taxation is nevertheless deemed to be comparable to the Austrian taxation.

In general, the international participation exemption is only denied if both tests are met. Nonetheless, if one test is failed marginally and the other test is clearly met, the exemption is nevertheless denied. If the participation exemption is denied, a switch-over to the credit method takes place. As a result:

- Dividends and capital gains from the foreign company become taxable at the level of the holding company;
- Upon application by the Austrian holding company, foreign corporate income tax on the profits of and withholding tax on the dividends from the foreign company are credited against the Austrian tax liability that is charged on the dividends and other distributions of income received by the Austrian company; the tax credit is itself subject to Austrian tax, much like a Section 78 dividend under U.S. tax law.

For example, if the foreign dividend is 100 and the creditable foreign tax is 10, the Austrian tax charge would be 25 (25% of 100) without tax credit; should the Austrian taxpayer file the application for the tax credit, the Austrian tax charge will be 17.5 (25% of 110 minus 10).

In case that creditable tax is higher than the Austrian tax burden, the tax credit can be carried forwarded and will be credited against future Austrian tax burden on application.

The participation exemption may also be denied under the general abuse of legal rights concept. Generally speaking, an abuse of a legal right occurs where a specific legal structure can only be explained by tax avoidance related to Austrian taxes. In connection with foreign subsidiaries of Austrian companies, the Austrian Administrative High Court ("*Verwaltungsgerichtshof*"), the highest tribunal in tax matters, frequently invoked the principle where it came to the conclusion that the foreign subsidiary had no economic function whatsoever. In cases of an abuse of a legal right, the foreign subsidiary is treated as a transparent vehicle with the result that its profits are directly taxed in the hands of the Austrian taxpayer.

5) Treaty Exemptions

As set out above, the domestic participation exemption regime is in some aspects more favorable than the international participation exemption since there is neither a minimum shareholding

required nor a minimum holding period. Under tax treaties that include an equal treatment clause, the Austrian company may enjoy the benefits of the international participation exemption for foreign companies resident in the jurisdiction of the treaty state if the conditions for application of the domestic participation exemption are fulfilled. Such clauses are provided by the double tax treaties with Ireland, Luxembourg, Sweden and Turkey.

c. Interest Deduction

As a general principle, costs relating to tax-exempt income are not tax deductible in Austria. However, interest payments (but not other costs) connected with the financing of (domestic or international) shareholdings are deductible despite the fact that income deriving from such participations is tax exempt. With effect of 2011, the deduction is no longer granted for interest payments in connection with the financing of the purchase of intra-group participations in order to hinder intra-group tax-avoidance structures.

iii. Group Taxation

Effective January 1, 2005, a group taxation concept replaced the former *Organschaft* concept. Under the rules now in effect, it is possible to tax all profits and losses derived by the members of a tax group at the level of the group head. However, a group taxation is an option which may be elected for each potential group member separately.

The group head must be an Austrian company or cooperative an Austrian-registered branch of a nonresident company or cooperative that is either an entity listed in Article 2 of the EC Parent/Subsidiary Directive (provided that it is comparable with an Austrian entity that qualifies as group head) or a company that is legally comparable to an Austrian company and has its seat and its effective place of management in a member state of the European Economic Area. Several companies may jointly act as group head provided that certain minimum holding requirements are met. Several entities may form a joint group head if certain participation thresholds are met.

Participating group members may be Austrian or comparable foreign companies or cooperatives; foreign entities, however, will qualify as a group member only if the financial integration requirement described below is exclusively fulfilled with regard to an Austrian group member or the Austrian group head.

To qualify as a group member of a tax group, the group head or an Austrian group member must hold a direct or indirect participation of over 50% in the Austrian or foreign subsidiaries that shall be part of the tax group. In case of a joint group head, one head company must hold at least 40% and the other head companies must hold at least 15% in the group member. The financial integration requirement must be met during the entire business year of the participating subsidiary. The Austrian group members must further file a written application with the revenue office, which binds the group members for at least three years.

All profits and losses of the Austrian members of the group are still calculated at the level of the group members, but taxed at the level of the group head. This treatment applies even when a person not being a group member holds a minority stake in one of the participating subsidiaries. For this reason it is necessary that the group members agree on compensation payments. These

agreements need not be annexed to the filing; it is sufficient that the group members confirm that such an agreement exists. The compensation payments themselves will be tax neutral in Austria.

With regard to foreign group members, only losses but not profits are taken into account. For the purpose of Austrian group taxation the foreign loss is computed in accordance with Austrian tax law; however, with effect from 2012, the deductible foreign loss is limited by the amount calculated according to the applicable foreign tax provisions. . When in the following years the foreign member can get a credit for the foreign loss against foreign profits (*e.g.*, by using a loss carry-forward provision) in accordance with the rules of the foreign tax law, then recapture rules apply with the result that, if such losses can be used abroad, the tax base of the group head will be increased by the amount of losses used abroad. Should the foreign member cease to be a member of the tax group, the tax base in Austria will be increased in an amount corresponding with the losses previously consolidated in Austria but not yet used against foreign profits. If the foreign group member ceases to exist because of liquidation or insolvency and a definite capital loss is incurred by the parent company, the recaptured amount is reduced by those write downs that were not tax effective during the period of group membership.

The group taxation regime does not only apply to subsidiaries resident in E.U. Members States, but also to subsidiaries anywhere in the world (although in practice "exotic" accounting rules can make it enormously difficult to integrate a foreign subsidiary into an Austrian tax group).

A negative effect of the group membership is that a write down of participations in the share capital of group members will not be deductible for tax purposes. This disadvantage is partly made up by the fact, that for Austrian resident companies, goodwill acquired by means of a share transaction deal is written down. If the acquisition costs of a shareholding exceed the net capital of the acquired company increased by hidden reserves of non-depreciable assets, the excess amount (capped at 50% of the acquisition costs) is capitalized and depreciated over 15 years.

D. Withholding Tax on Outbound Payments

i. Dividend Payments

Generally, dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 25%. Dividends paid by an Austrian company to its E.U.-resident parent are exempt from taxation under legislation implementing the E.U. Parent/Subsidiary Directive if the parent company holds directly a participation in the Austrian subsidiary of at least 10% for a minimum period of one year. If payments are made before the minimum holding period has elapsed the payment is subject to withholding taxation, the parent company however, is entitled to a refund once the minimum holding requirement has been met. In addition, tax has to be withheld in cases suspect to abuse according to Section 94, nr. 2 of the Austrian Income Tax Act. ("I.T.A."). Abuse is, in particular, assumed if the parent company is not actively engaged in business, does not have a number of employees or its own office. In such cases, withheld tax is refunded on application of the parent company provided that the abuse suspicion is rebutted.

Withholding tax rates are further reduced under most tax treaties to ordinarily 15% (portfolio dividends) or 5% (non-portfolio dividends) and in some cases even to zero percent (*e.g.*,

Bulgaria). Austria has over 100 income tax treaties currently in effect, as illustrated in the following table:

Albania	Egypt	Liechtenstein	Singapore
Algeria	Estonia	Lithuania	Slovakia
Armenia	Finland	Luxembourg	Slovenia
Azerbaijan	France	Malta	Spain
Australia	Germany	Macedonia	South Africa
Barbados	Georgia	Mexico	Switzerland
Bahrain	Greece	Morocco	Sweden
Belarus	Hong Kong	Moldova	Syria
Belgium	Hungary	Mongolia	Tajikistan
Belize	India	New Zealand	Thailand
Bosnia and	Indonesia	Nepal	Tunisia
Herzegovina	Iran	Netherlands	Turkey
Brazil	Ireland	Norway	Turkmenistan
Bulgaria	Israel	Qatar	United Kingdom
Canada	Italy	Pakistan	Ukraine
Chile	Japan	Philippines	United Arab Emirates
China	Korea	Portugal	United States
Croatia	Kazakhstan	Romania	Uzbekistan
Cuba	Kirgizstan	Russia	Venezuela
Cyprus	Kuwait	San Marino	
Czech Republic	Latvia	Saudi Arabia	
Denmark	Libya	Serbia	

ii. Capital Gains

Nonresident shareholders are generally subject to taxation on the disposition of shares in an Austrian company if the shareholder has held 1% or more of the share capital for any time during the preceding five years (if the participation has not exceeded this threshold, capital gains are not taxable). For corporate shareholders, corporate tax is levied at the regular corporate tax rate of 25% on the realized gains. Gains realized on the liquidation of an Austrian company are subject to corporation tax regardless of the extent of the shareholding.

However, Austria has waived its right to tax capital gains from the disposal of shares under most of its tax treaties according to the O.E.C.D. Model Convention. See Article 13/4 Model Convention.

iii. Royalties

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%; expenses are not deductible. However, under most tax treaties the withholding tax is reduced or eliminated altogether (*e.g.*, Germany, Poland, Hungary, and Croatia). If the receiving company is resident in an E.U.-member or E.E.A.-member state, it may deduct

expenses directly connected to the royalty income from the withholding tax base; however, the withholding tax will then increase to 25%.

Effective January 1, 2004, Austria adopted the Interest/Royalties Directive. The new Section 99a I.T.A. applies to interest and royalty payments made after December 31, 2003 to associated companies of a type listed in the Annex to the Interest/Royalties Directive or their permanent establishments that are located in an E.U. member state, subject to the recipient qualifying as the beneficial owner of such payments.

Companies qualifying as parent, subsidiary or sister companies are deemed to be 'associated' for the purposes of the directive. In any event, the parent company must directly hold at least 25% of the capital of the subsidiary for an uninterrupted period of one year. Furthermore, all companies involved in the structure of the corporate body must be resident within the E.U. A company is treated as the beneficial owner of interest and royalties only if it receives such payments for its own benefit and not as intermediary (*e.g.*, an agent, trustee or authorized signatory) for some individual.

The concept of royalties includes payments of any kind that are received as consideration for (i) the use of, or the right to use, any copyright (whether literary, artistic or scientific), software, patent, trademark, design, model, plan, secret formula or process, (ii) information concerning industrial, commercial or scientific matters, or (iii) the use of, or the right to use, industrial, commercial or scientific equipment.

Section 99a I.T.A. further requires that (i) the right be related to the assets of the recipient company, and (ii) payments qualify as tax deductible expenses when made by a permanent establishment, although deductibility does not apply if interest or royalties are paid by a permanent establishment to its head office.

If at the time of the payment the holding requirement has not been met yet or the Austrian debtor company has not yet had the required documentary evidence the withholding tax can be refunded upon request. The Austrian tax authorities are further free to deny an exemption if a corporate group structure was established with a view to tax avoidance (in which case the Austrian company will be held liable for withholding tax if it applied the exemption).

iv. <u>Interest</u>

Interest payments to non-Austrian residents are generally not subject to tax. This exemption from taxation extends to income from debt-claims that carry a right to participate in the Austrian debtor's profits unless the contractual relationship is characterized as a silent partnership.

However, income from debt-claims secured by Austrian real estate is subject to withholding tax at a rate of 25%. Interest payments to E.U. companies and permanent establishments are exempted according to Section 99a I.T.A. if the requirements of the Interest and Royalties Directive already outlined hereinbefore are met.

In case of shareholder loans special attention must be given to structuring the loan properly. Under the general anti-avoidance principles the interest accruing on the loan may be subject to

withholding tax as a hidden distribution of profits if the terms of the loan do not meet the requirements of an arm's length test.

Given the fact that Austrian tax law does not provide for statutory thin capitalization rules, debt financing is an attractive method for repatriation of profits from an Austrian holding company to its foreign parent company.

v. Other Income

A 20% withholding tax is levied on fees for technical and commercial consulting services rendered by a nonresident. However, Austria waives its taxing rights under most tax treaties.

E. Other Tax Issues

i. Wealth Tax

Austria currently does not impose a wealth tax, neither on Austrian companies nor on individuals. Future tax reforms may reintroduce a general wealth tax, which was abolished in 1994. The only wealth tax currently imposed is an annual tax on Austrian real estate.

ii. Anti-Avoidance Legislation

There are only a few specific statutory anti-avoidance provisions in Austrian tax law, the most noteworthy being the aforementioned provisions relating to the international participation exemption. In particular Austria does not have C.F.C. legislation nor thin capitalization legislation. Transfer pricing issues are dealt with in accordance with general anti-avoidance principle, in particular the arm's length principle.

iii. Foreign Tax Credit

By a Double Taxation Directive of the Ministry of Finance, certain items of foreign source income are exempt from Austrian taxation, in particular income from immovable property, business income attributable to a foreign permanent establishment and income derived from building sites or construction or installation projects, if the following requirements are met:

- The Austrian taxpayer derives income from sources in a country with which Austria has not concluded a tax treaty;
- The foreign state imposes a tax on the income which is comparable to the Austrian income taxation or corporation income taxation; and
- The average foreign tax rate computed in accordance with Austrian tax principles exceeds 15%.

The credit method applies to all foreign source income that is neither exempt from taxation according to foregoing rule nor subject to a tax treaty. The foreign tax credit is capped at an amount corresponding to that part of the Austrian tax that is attributable, as computed before the

deduction is given, to the income from sources of the foreign country in question. There are, however, no "basket" rules for the foreign tax credit.

11. FRANCE

In order to tighten the fight against tax avoidance, the Finance Amendment Bill for 2009, has set up a black list of Non-Cooperative Countries and Territories ("N.C.C.T."s). The list is updated annually. A country or territory is defined as an N.C.C.T. if it meets the following criteria:

- It is not a member State of the European Union;
- It is reviewed and monitored by the O.C.D.E. global forum on transparency and exchange of information;
- It has not concluded at least 12 tax information and exchange agreements ("T.I.E.A."s) before January 1, 2010 and;
- It has not signed a T.I.E.A. with France.

An updated list of 8 N.C.C.T.s was published in April 2012 which includes the following states:

Botswana	Brunei	Guatemala
Marshall Islands	Montserrat	Nauru
Niue	the Philippines	

This list is subject to modifications according to recent developments concerning new tax treaties and the efficiency of exchange of information under the treaties and T.I.E.A.'s.

Anti-abuse provisions are tightened if one of these countries is involved. Also, a withholding tax of 50% applies to payments of interests and royalties made in those countries increased to 55% in the case of dividends (see below).

A. Corporate Income Tax ("C.I.T.") – General

The standard corporate income tax is 33.33%. However, an additional social contribution of 3.3% of the C.I.T. amount may apply on the fraction of the C.I.T. which exceeds € 763,000 (practically speaking where the taxable profits is higher than €2,289,000). The effective tax rate is then 34.43%. Lower rates apply to S.M.E.'s.

The 4th Finance Amendment Bill for 2011 introduced a temporary contribution of 5% of the C.I.T. due for fiscal years closed from December 31, 2011 until December 31, 2013. This contribution only applies to companies which annual turnover exceeds €250 million (including the turnover realized outside of France). Added to the above mentioned 3.3% surcharge, the effective tax rate may then reach 36.1%.

B. Net Operating Losses (“N.O.L.s”)

The second Finance Amendment Bill for 2011 restricted the possibility to use N.O.L’s for fiscal years closed as from September 21, 2011.

i. Carryforward

N.O.L.s can still be carried forward with no time limit. However, for the financial years closed as from September 21, 2011, the N.O.L.s that can be offset against the taxable income is limited to the first €1 million of taxable profit plus 50% (60% previously) of the taxable profit exceeding €1 million for the financial years closing as of December 31, 2012.

ii. Carryback

N.O.L.s incurred by companies subject to C.I.T. can be offset against the taxable income realized in the immediately preceding tax year only (instead of the three preceding tax years as previously permitted) starting with financial years ending as of September 21, 2011. Thus, a loss incurred in 2012 can only be carried back and used against taxable income in 2011with no ability to go further backward. Furthermore, the amount of N.O.L.s that can be carried back is now limited to the lesser of €1 million and the taxable income realized in the immediately preceding tax year. The carry back gives rise to a credit in an amount determined by applying the rate of C.I.T. in effect in the year to which the losses are carried back against the amount of losses actually carried back. This credit can be (i) reimbursed at the end of the five-year period following the year during which the losses were incurred, or (ii) used before that date for the payment of the C.I.T. that may be due during the five years following the election to carry back, or (iii) offered as a guaranty to a credit institution.

C. Participation Exemption or D.R.D on Dividends

French corporate shareholders are exempt under the 95% dividends received deduction (“D.R.D.”) or otherwise fully taxed at 33.33%[40] on the amount of the dividends received without deduction or tax credit.[41]

French or foreign source distributions are subject to C.I.T. unless the D.R.D. (“*régime mère fille*”) applies.

Under the French Tax Code (“F.T.C.”), Sections 145 and 216, dividends received by entities subject to C.I.T. are excluded if:

- The shares are in registered form or deposited with an accredited institution,

[40] Or 34.43% or 36.1% as the case may be.

[41] For individual shareholders, only 60% of the amount of the distribution received is taxable (40% exclusion). The same exclusion applies to dividends received from either Treaty protected distributing companies with an eligible exchange of information clause in the Tax Treaty or from companies established in the European Union. This 40% exemption may however be repealed in the upcoming months.

- The corporation receiving the dividend holds at least 5% of the capital of the company making the distribution, and

- The corporation must hold the stock giving rise to the tax-free dividend for at least two years.

The 5% threshold refers to both financial and voting rights. It is not required that every stock forming the substantial shareholdings carry a voting right. This is favorable for corporate shareholders holding preferred stock with different rights. Consequently, if the shareholdings as a whole reach the 5% threshold, it is irrelevant whether some shares are voting or non-voting or carry restricted voting rights. The 5% test must be met at the time the distribution is actually made. A corporate shareholder holding restricted voting rights must demonstrate that it participates in the most important decisions of the company. The authorities are expected to release new guidelines.

In applying the third test, the exemption applies from the first day of the 5% holding, provided the holding period is ultimately maintained for two years. Failure to keep the shares for two years will result in a claw-back of the exemption. Late payment interest along with the applicable C.I.T. must be paid within three months from the date of the disposal of the shares of stock. If a tax-free reorganization such as merger or transfer of a business as a going concern under F.T.C. Sections 210 A and 210 B takes place before the two-year holding period is achieved, it will not result in a claw-back of the exemption. A carryover of holding period exists for D.R.D. purposes.

Dividends from certain entities do not qualify for the D.R.D. The list of excluded stock includes shareholdings in French or foreign R.E.I.T.'s (S.I.I.C. in France; S.I.C.A.F. in Belgium, and BI in the Netherlands). This development is not critical when it comes to U.S. R.E.I.T.s, as there rarely, if ever, is a 5% shareholder in a U.S. R.E.I.T. In any event, the U.S.-France Income Tax Treaty allows a French investor to credit the 30% or 15% tax levied in the U.S.

The dividend distribution is exempt from C.I.T., with a recapture corresponding to a service charge ("allotment for expenses and costs") equal to 5% of the amount of the dividends distributed.

N.O.L.s could be used against that taxable profit. The D.R.D. is not applicable to profits[42] distributed by venture capital companies or listed real estate companies ("*Société d'investissement immobilier cotée*" or "S.I.I.C.", the French equivalent of U.S. R.E.I.T.'s).

Financing costs are deductible subject to the thin capitalization rules (see below).

The D.R.D. applies to dividends from foreign subsidiaries with no limitations other than the conditions set forth above. Foreign tax that is withheld in the source country for dividends received from foreign subsidiaries may be used as a credit against any French withholding tax

[42] Profits distributed by venture capital companies or S.I.I.C. that have been excluded from corporate income tax.

that might be due upon the further distribution of the dividend to a foreign shareholder of the French company.[43] Otherwise, the tax withheld at source is not recoverable.

As of March 1, 2010, dividends distributed by a company established in an N.C.C.T. (which is black listed) are not eligible to the D.R.D.

D. **Tax Consolidation**

Under Sections 223 A *et seq.* of the F.T.C., a French company, or a French branch of a foreign company, holding directly or indirectly (either through a French company or, subject to certain conditions, through an E.U.-resident company or a Norwegian or Icelandic company) at least 95% of the capital and voting rights of other French companies or branches of foreign companies, may file a consolidated tax return.

The following conditions apply:

- All the tax-consolidated group's members must be subject to French C.I.T. and have the same financial year,
- The head of the tax group or consolidating company must not be held at 95% or more by another French company subject to French C.I.T., either directly or indirectly through companies subject to C.I.T. and held by 95% or more by such French company,
- The 95% direct or indirect holding (even through an E.U.-resident subsidiary or a Norwegian or Icelandic subsidiary) of the subsidiaries or branches by the parent company must be satisfied throughout the entire financial year,
- Adequate tax group elections must be filed in a timely manner (filing deadline matching the deadline for filing C.I.T. annual returns).

The consolidating company is liable to C.I.T. on the group taxable result which is determined by adding all members' profits and losses, subject to certain adjustments (such as the neutralization of intra-group transactions and distributions).

An anti-debt-push-down provision under Section 223 B known as "Charasse Amendment" restrict the possibility to deduct interest expenses where (i) a member of a tax-consolidated group purchases from its controlling shareholders, shares of a company that (ii) subsequently becomes part of the same tax-consolidated group. In such case, the acquiring company must add-back part of its interest expenses for tax purposes during the year of said acquisition and the following 8 years.[44]

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[43] Doc. Adm. 4 K 1121, December 15, 1989.

[44] Interest expenses disallowed under the Charasse Amendment are determined on the basis of the following formula: (interest expenses of all tax group members) x (acquisition price / average indebtedness of all tax group members).

Tax consolidation proves to be a powerful tool for LBOs since it combines consolidation and tax free distributions.

E. Special contribution on distributions

Companies (that are not S.M.E.'s) are subject to a special contribution in addition to the C.I.T. of 3% of the distributed amounts as of August 17, 2012. This special contribution, treated as C.I.T. (and not as distribution tax), is not deductible. The special contribution hits dividends and distributions as defined by French tax law. This contribution is not applicable within a tax consolidation context and to dividends paid in shares (if the shares are not cancelled[45] within one year by the issuing company).

F. Withholding Tax ("W.H.T.") on Dividends

i. Outbound Dividends Within the E.U.

a. E.U. Directive Exemption

Under Section 119 *bis* 2 of the F.T.C., a 30% withholding tax is levied on the outbound dividend payments subject to treaty law or E.U. law. However, dividends could be paid free of withholding tax to qualifying E.U. parent companies subject to a 5% ownership test if the E.U. parent cannot recover the French source withholding tax (the "5% E.U. Exemption"); otherwise, the dividend could still be paid free of withholding tax subject to a 10% ownership test ("E.U. Directive Exemption").

This exemption applies if the following tests are met:

- The distributing company is incorporated under the legal form listed in an appendix of the Directive. Eligible entities include "*Société Anonyme*", "*Société Anonyme Simplifiée*"[46], "*Société En Commandite Par Actions*", "*Société A Responsabilité Limitée*" and the European Company ("*Societas Europaea"*);

- The shareholder corporation is the beneficial owner of the dividends distributed;

- The distributing corporation is subject to C.I.T. without exemption;

[45] Through a share buyback program not aiming at purging losses of the company (under section L 225-207 of the Commercial Code).

[46] The scope of the eligible French legal forms was extended to the SAS by administrative regulations 4-J-2-95 dated October 11, 1995.

- The shareholder corporation is an E.U. resident defined as having its place of control and management in another Member State and having a legal form listed in the Directive; and

- The shareholder corporation holds directly 10% or more of the capital of the distributing company. The shares must be held for at least two years. However, the E.U. Directive Exemption can be claimed before the expiration of that period.

The dividend can be paid to a permanent establishment in the E.U. of an eligible shareholder corporation.

An anti-abuse provision denies the E.U. Directive Exemption where a non-E.U. corporate shareholder directly or indirectly controls the beneficial owner unless the beneficial owner can demonstrate that taking advantage of the E.U. Directive Exemption was not a principal purpose for the ownership structure (the "purpose test"). According to guidelines released by the tax authorities, the tainted purpose does not exist where the overall withholding tax cost through the ownership chain up to the non-E.U. ultimate controlling shareholder is equal to the withholding tax burden for which the non-E.U. controlling shareholder would have been liable had the dividend been paid directly to the non-E.U. controlling shareholder. The test is also satisfied if the ownership chain was in place before July 23, 1990, *i.e.,* at the time the directive was adopted.

b. <u>5% E.U. Exemption</u>

This exemption results from the guidelines issued by the French Tax Authorities [47] following the E.C.J. *Denkavit* decision.[48]

The following requirements must be met:

- The shareholder must enjoy an exemption regime in his own country of residence. This is to say that the recipient shareholder must not be in a position to credit the French withholding tax against its own tax;

- The shareholder must be a resident of the European Economic Area or the European Union, provided that the recipient shareholder's country of residence has entered into a qualifying tax treaty with France;

- The parties must not have entered into an "artificial arrangement" for tax avoidance;

- The stock must constitute 5% of the capital and voting rights of the distributing company, the stock must be registered shares or be kept by a financial establishment, and the stock must be held for at least two years.

When the above conditions are met, the French withholding tax exemption automatically applies.

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[47] Guidelines 4-C-7-07 dated May 10, 2007

[48] ECJ Denkavit, C 170-05, December 14, 2006

In other words, if the qualifying E.U. shareholder is not taxed on the French source dividends, as is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or more interest in the French distributing company. If the dividend is taxed in the jurisdiction of the residence of the E.U. shareholder, the dividend may still be paid gross if the E.U. qualifying corporate shareholder owns 10% or more of the French distributing company.

One may rely on tax treaty law 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.

ii. Outbound Dividends Outside E.U.

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 a zero withholding tax on dividends (see above). Other income tax treaties have a narrow definition of dividend that restricts the application of the dividend provision to distributions that qualify as dividends under corporate law, only.[49] Consequently, distributions that are treated as dividends under tax case law may not be covered by the dividends article. An example is an exceptional distribution of reserves. As a consequence and to the extent that the other operative provision in the tax treaty applies, withholding tax may not be due. This situation may also arise in the tax treaties with the Netherlands and Luxembourg.

As of January 1, 2012, dividend payments made in N.C.C.T.s are subject to a withholding tax of 55%.

iii. Dividends from Foreign Subsidiaries

The D.R.D. may apply even if the subsidiary's profits were not subject to tax unless the distributing company is established in an N.C.C.T.

In addition, when a French company owned by nonresident shareholders receives a dividend from abroad and pays a dividend to its foreign shareholders, French law provides that the French company may claim a foreign tax credit against its dividend withholding tax obligation in an amount equal to the foreign withholding tax levied on the inbound dividend.[50]

G. Capital Gains Tax on Shareholdings – Exemption.

Gains on the sale of stock are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for Capital Gains Tax ("C.G.T.") relief. Relief is available in the form of an exemption or through a reduced rate of taxation.

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[49] For example, the French Administrative Supreme Court held that deemed distributions do not fall within the scope of the dividend article but rather the other income article, resulting in an exemption from W.H.T. in France (CE October 13, 1999, *SA Banque Francaise de l'Orient*, RJF 12/99 #1587).

[50] Doc. Adm. 4 K 1121, December 15, 1989.

C.G.T. on substantial shareholdings include two baskets: one giving rise to a reduced tax of 15.49%[51] tax (the "Tax Basket") and the other one giving rise to an exemption (the "Exempt Basket")

Both baskets cover gains on disposition of substantial shareholdings which include shares or interests that the shareholder intends to hold as long-term investments, *viz*., at least two years. They must be sufficient to provide the shareholder with control of, or significant influence over, the company. This condition is deemed meet with a holding of at least 5% in the company. Stock in N.C.C.T.'s will not be eligible to the C.G.T. relief as of January 1, 2011.

Regarding the exempt basket, gains on certain substantial shareholdings are exempt subject to a 10% add-back, which brings the effective tax rate to 3.44% of the gain, unless N.O.L.s are available.[52] Shareholdings giving rise to the D.R.D. with a minimum 5% ownership test, or shares acquired in a takeover bid or in a stock tender offer, are treated as substantial shareholdings for C.G.T purposes.

Regarding the Tax Basket, disposition of shares in listed real estate holding companies for whom more than 50% of French assets consist of real estate are eligible for the Tax Basket if the substantial shareholding requirements are met. A special C.G.T. rate of 19.62%[53] applies. Disposal of shares of private real estate holding companies are subject standard C.I.T. Venture capital funds interests in an F.C.P.R. or an S.C.R. that are held for more than five years are eligible for the Tax Basket, but only as to the fraction of the gain which is not exempt under special rules.

Gains subject to the Tax Basket must be netted each year against the same basket's capital losses. Ordinary losses can be used against any given year's Tax Basket gain.

For fiscal years closed, as from December 31, 2010, deduction of short term capital losses incurred upon the transfer of shares held for less than 2 years to a related party is deferred until the shares are effectively transferred to a non-related party.

Capital gains exemption may be abolished by the new government of the new French president elected in May 2012.

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[51] The 15% tax rate is increased by the 3.3% surcharge mentioned under Section A above. Where the company is subject to the 5% additional contribution, this effective tax rate is 16.24%.

[52] In other words, the gain will be fully exempt and the corporate taxpayer should add back 10% of the gain's amount to its taxable profits, which brings the effective rate of taxation to 3.44%. Where the company is subject to the 5% additional contribution, this effective tax rate is 3.61%.

[53] This consists of the 19% tax rate increased by the 3.3% surcharge mentioned under Section A above. Where the company is subject to the 5% additional contribution, this effective tax rate is 20.57%.

H. Other Tax Items

i. Deductibility of Interest Charge

For the time being, interest paid on a debt-financed acquisition of shares is deductible (subject to thin-capitalization limitation, see below) even if the shareholder qualifies for D.R.D. on dividends and exemption on capital gains.

However deductibility of interest charge in such context is now on the agenda of the new government which aims at limiting too aggressive tax planning with the use of French holding companies. Further limitations may therefore be enacted this year. The tax barriers adopted in Germany, Italy and Spain may not be introduced in France even if it was investigated by the French former government within the frame of German-French convergence effort.

a. Limitation for holding companies

As part of the 4th Finance Amendment Bill for 2011, a new anti-abuse rule known as "Carrez Amendment" was introduced under Section 209 IX F.T.C. whereby interest charge incurred in connection with the acquisition on substantial shareholdings in a subsidiary may be fully deducted if the French acquiring company demonstrates that the following cumulative conditions are met:

- "*Decisions related*" to the shares are effectively made in France, by the acquiring company itself or by a parent or a sister company established in France only; and
- Where the French acquiring company actually exercises a "*control or influence*", this "*control or influence*" is effectively exercised in France by the same entities.

If the company is not in a position to perform the required demonstration in a financial year, interest charge have to be recaptured until the end of the 8th year following the acquisition.

This text aims at preventing foreign based groups to use French holding company to acquire foreign or French target companies and to claim a deduction of the interest of the acquisition debt against other French operations (through tax consolidation) or against the target's profits (if based in France). Such attempts proved vain through litigation.

The exclusion in case of decision making process at the level of the Parent or sister company established in France proves discriminatory vis-à-vis foreign based groups and may be challenged based on E.U. law (obstacle to the freedom of establishment) and Treaty law (in case the treaty include an article preventing discrimination towards subsidiaries of parent companies established in the country of the treaty partner comparable to article 24.5 of the O.E.C.D. model tax treaty).

This rule would not apply under three exceptions: (i) shares acquired with a fair market value not exceeding €1 million, (ii) acquisition is not financed, directly or indirectly, through debt, (iii) the consolidated debt-to-equity ratio of the group is equal or even higher than the debt-to-equity ratio of the French acquiring company.

The scope of this new regime is still subject to discussions and administrative guidelines should be published in the upcoming months. Alternatively, this text may be abolished with the introduction of a more general limitation on deductibility of interest paid in relation to the acquisition of substantial shareholdings giving rise to exempt dividends and gains.

In any event, the mechanism may be combined with thin capitalization limitations (see below) and anti-debt-push-down limitations within a consolidation context (see Paragraph D of this chapter). In such case, the French tax authorities consider that it shall apply in priority to the thin capitalization rules and debt push-down limitations.

b. Thin Capitalization

French thin capitalization rules provide for two cumulative tests regarding loans extended by related entities: the interest rate test and the leverage test. The rules also apply to wholly domestic transactions.

Related-party debt within the scope of the limitations include debt extended by the controlling shareholder (either direct or indirect) and sister companies that are under control of the same shareholder ("Affiliates"). A shareholder directly or indirectly holding at least 50% of the capital of the French indebted company, or exercising control over the company decisions, is regarded as controlling the company for purposes of the thin capitalization rules. For fiscal years closed as of December 31, 2010, third party debts which are guaranteed by related parties are assimilated to related-party debt for thin-capitalization purpose. However, this extension of the scope of the thin capitalization rules does not apply to debts related to:

- Bonds offered to the public;

- Loans secured by a pledge if the pledge is (i) over the shares of the borrower (*e.g.*, a parent company gives a pledge on shares of a French subsidiary to guarantee the loan granted by a bank to the subsidiary), or (ii) on receivables held by the parent company on its direct subsidiary, or (iii) over securities of a direct or indirect shareholder of the borrowing entity, provided that the entity which grants the pledge and the borrower are members of the same French tax-consolidated group;

- Refinancing resulting from the mandatory repayment of a pre-existing debt after a change of control of the borrower;

- Loans contracted prior to January 1, 2011 for the purpose of an acquisition of securities, or refinancing contracted prior to January 1, 2011 for loans granted for the purpose of an acquisition of securities.

Under the interest rate test, the deduction of interest paid to shareholders is limited to interest whose rate is not higher than the annual average interest rate granted by credit institutions to companies for medium-term loans of two years or more (3.99% for 2011) unless the French borrower can demonstrate that the rate is a market rate (transfer pricing safe harbor). A market

rate is a rate that the company could have obtained from independent banks under similar circumstances. The transfer pricing safe harbor rate cannot be claimed by minority shareholders that are not affiliated with a controlling shareholder.

Excess interest paid to affiliates under the interest rate test is treated as a distribution eligible for the D.R.D. within a wholly domestic situation or which may be subject to withholding tax (subject to the treaty law) with a non-French affiliate lender. Some tax treaties may deny France the right to tax the deemed distribution where the dividend article does not encompass deemed distribution. (See*, e.g.,* Luxembourg and the Netherlands).

The leverage test applies to affiliates only and not to minority shareholders. It is then applied on the allowed fraction of the interest under the interest rate test to determine if the interest expense is actually deductible.

Deductions claimed for interest expense will be disallowed when the creditor is an Affiliate and the following three tests are met:

- The related-party debt exceeds 1.5 times the amount of the net equity (taking into account related-party debt only);
- 25% of the operating profit before tax, related-party interest expense, depreciation, amortization, and certain specific lease payments is less than the actual related-party interest; and
- The interest paid to related parties exceeds the interest received from related parties.

The disallowed interest is equal to the highest of the above limitations. If it is less than €150,000 or if the disallowed interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group, the interest is allowed.

The disallowed interest can be carried forward to offset profits of the following years (up to 25% of the profit before tax and after deduction of current allowed related party interest). A reduction of 5% applies each year from the second carryover year.

The rules provide two safe harbors. First, a 1.5-to-1 debt-to-equity ratio safe harbor as seen above.

Second, a worldwide group safe harbor applies. Under the worldwide group safe harbor, the interest expense deduction will not be limited if the French borrower demonstrates that the disqualified interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group. Related-party debt and reciprocal transactions within the worldwide group should be set aside when computing the debt-to-equity ratio of the worldwide group. The worldwide leverage safe harbor does not allow for the split of the leverage test by industry within the worldwide group even though degree of leverage generally differs from one industry to the next.

Interest exceeding the higher of the above limits is not tax deductible, but can be carried forward within certain limits (they are deductible within the limit of 25% of the current income before taxation). Further, the interest deduction is reduced by 5% annually from the second year of the carry-forward period. The excess interest is not regarded as a deemed distribution. No withholding tax should apply, especially where the recipient is treaty protected.

Among companies filing a consolidated tax return, the thin capitalization rules are applied at the level of each member on a stand-alone basis. The aggregate of disallowed interest may be deducted from the consolidated tax profit for an amount that does not exceed the difference between (i) the aggregate of the related party interest paid by companies filing a consolidated tax return to non-consolidated entities and carryovers of pre-consolidation disallowed interest which were deducted during the consolidation and (ii) 25% of the operating profits of member companies before tax.

Banks and certain financial institutions are excluded from the scope of the new thin capitalization rules. In addition, related-party debts within the course of cash-pooling arrangements or asset-financing transactions involving leases or "credit bail" contracts may not be considered for computation purposes for the purpose of those activities only.

Last but not least, within a tax grouping context, an anti-debt-push-down mechanism restricts the deductibility of interest. See Charasse Amendment discussed in Paragraph D, above.

ii. <u>Withholding Tax on Interest – Exemptions</u>

According to Articles 119 *bis* 1 and 125 A III of the F.T.C., a 30% withholding is levied on interest paid to a nonresident recipient. However, French domestic tax law provides for several exemptions, resulting in the almost systematic exemption of withholding tax. We have outlined three of these exemptions for (i) interest on loans (ii) interest on bonds, and (iii) interest paid inside the E.U.

a. <u>Interest on Loans</u>

Until March 1, 2010, interest could be paid free of withholding tax where:

- The initial lender is a nonresident individual or legal entity established outside of France;
- The loan is documented by an agreement executed before the loan proceeds are transferred to the French company;[54] and
- The loan agreement sets forth the principal, the date of repayment, the interest rate, and any additional remuneration to the lender.

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[54] This requirement is open to question and has given rise to conflicting decisions from French courts.

The subsequent sale or assignment of the receivable should not jeopardize the application of the exemption.

From the 1st march 2010, according to article 125 A III of the F.T.C, no withholding tax should apply to the interest paid by a French company to a nonresident company with no further formalities.

However, in regard of the new N.C.C.T. rules, a 50% withholding tax applies to interest payments made on an account held in an N.C.C.T.

b. <u>Interest on Bonds</u>

Under articles 119 *bis* 1 of the F.T.C., interest paid to nonresidents on bonds issued by French issuers is exempt from withholding tax provided the securities were issued after January 1, 1987. Under article 125 A III of the F.T.C., the levy at source is not applicable to interest on bonds ("*obligations*") issued after October 1, 1984 paid by a debtor domiciled or established in France, if the beneficial owner of the interest demonstrates that he has his 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*").

c. <u>Interest Paid to an E.U. Related-Company</u>

The recipient is an E.U. eligible company that is subject to corporate income tax in its jurisdiction of residence. The "payor" and the "beneficial owner" must be related parties. Parties will be treated as related where (i) the payor or the beneficial owner directly owns at least 25% of the capital of the other party or (ii) a third E.U company directly holds at least 25% of the capital of both the payor and the beneficial owner. The ownership interest must be held for at least two years. Payments made before the expiration of such two-year period can be exempted from withholding tax if the shareholder undertakes to hold the ownership interest for at least two years. An E.U. permanent establishment of an E.U. eligible company can be treated as an eligible party (either payor or beneficial owner) as long as the interest is subject to corporate income tax in the E.U. Member State where the P.E. is constituted. The beneficial owner of the payments must give to the payor all the required evidence that the tests have been fulfilled.

The exemption includes an anti-abuse provision under which the exemption may be denied where the beneficial owner is controlled directly and indirectly by a non-E.U. corporate shareholder and obtaining the tax benefit is a principal reason for the structure. (See Paragraph E.i.a of this chapter, above, for E.U. dividends.) A decree should clarify the situations covered by the anti-abuse rule. However, where an income tax treaty entered into by France with the jurisdiction of residence of the controlling shareholder provides for a zero withholding tax on interest, the anti-abuse provision may be of little practical importance. The U.S. is an example.

In addition, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments by a French company. Thus, each of the income tax treaties between France and

Germany, Austria, the U.K., Greece, Ireland and Sweden provides for zero withholding tax on interest.

iii. C.F.C. Legislation

Article 209 B is the French counterpart of "Subpart F" of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d'Etat,* struck down article 209 B as discriminatory under the French-Swiss Tax Treaty.[55] The *Conseil* found that article 209 B indeed amounted to a tax on French business profits of the foreign company, which, in the absence of a permanent establishment in France, was precluded by the France-Switzerland Income Tax Treaty applicable at that time. In addition, article 209 B was clearly at odds with the principle of free establishment protected by the E.C. Treaty. The C.F.C. rules were therefore revisited and reformed.

The law changed effective January 1, 2006. The C.F.C. rules apply both to foreign enterprises (namely permanent establishments) and to foreign entities. The foreign entities should be "established or formed" in a foreign country. They include legal entities whether or not distinct from their shareholders (*viz*., companies, partnerships, associations, etc.). They also include trusts.

The holding threshold increases from 10% to "more than 50%" for the foreign entity to be treated as a C.F.C. under article 209 B. However, that threshold drops to 5% if 50% of the legal entity is held directly or indirectly by other "French enterprises," even if unrelated under a control test.[56] In case of related enterprises, the 5% test applies even if the related enterprise is not established in France. The alternative threshold of €22,800,000 has been repealed.

The new provisions do not replace the current anti-abuse provision pursuant to which an interest held by "sister entities" (whether French or foreign), is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is subject to C.I.T. at a rate below 16.66 % (50% of the French C.I.T.).

Section 209 B provides an E.U. exclusion. The C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a "*wholly artificial arrangement, set up to circumvent France tax legislation*." This provision follows the case law developed by the European Court of Justice (E.C.J.) and more particularly *Cadbury*

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[55] CE, June 28, 2002, *Ministre de l'Economie, des Finances et de l'Industrie c/ Sté Schneider Electric*, n°232276, RJF 10/02, n° 1080.

[56] Control means (i) holding directly or indirectly the majority of the share capital of the "controlled" entity, or (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.

Schweppes.[57] In this case, the E.C.J. decided that the C.F.C. was not artificially established when it participated in the economic activity of the host country with the required substance (offices, etc.) and that the subjective intent of the establishment (*i.e.*, as tax planning) was not material.

A second exclusion (the "Trade or Business Exclusion") may apply for C.F.C.s established in non-E.U. countries.

In case the C.F.C. derives passive income from financial activities or the management of intangibles, the exclusion applies unless the passive income comprises more than 20% of the profits of the C.F.C. or 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 that case, the French taxpayer must demonstrate that using the foreign entity or enterprise does not primarily result in locating profits in a low tax jurisdiction.

From March 1, 2010, where the C.F.C. is established in a N.C.C.T., the trade and business exclusion does not apply unless the taxpayer justify the effectiveness of the business carried out and the compliance with the 20% and 50% rations.

If the C.F.C. does not qualify for either the E.U. or the Trade or Business Exclusions, the French taxpayer may still justify that the setting up of the C.F.C. does not primarily result in locating profits in low tax jurisdictions in order to avoid the taxation of C.F.C's profits to France.

In response to the 2002 decision of the *Conseil d'Etat*, the new law provides that profits derived from the legal entity established or formed abroad and attributed to the French company by virtue of article 209 B would be treated as "deemed distributions." The French Tax Authorities (the "FTA") contend that under these conditions, the conflict with the tax treaties would be eliminated.

N.O.L.s of the French company are available to reduce the taxable income arising from the attribution of profits from a C.F.C. Moreover, tax credits of the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

iv. Transfer Pricing

The arm's length principle applies to transactions between related parties. France follows the O.E.C.D. guidelines.

As of January 1, 2010, transfer pricing documentation is mandatory in France for (i) French companies with a gross annual turnover or gross assets equal to or exceeding €400 million; (ii) French subsidiaries of foreign based group when more than 50 % of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €400 million criteria;

[57] E.C.J., September 12, 2006, *Cadbury Schweppes*, C-196/04 and among others: E.C.J., July 16, 1998, *Imperial Chemical Industries plc*, C-264/96, and guidelines issued by the FTA dated January 16, 2007 (4-H-1-07).

(iii) French parent companies that directly or indirectly own at least 50 % of companies meeting the €400 million criteria; or (iv) worldwide consolidated (without any financial threshold) or tax consolidated French companies (with at least one tax consolidated entity meeting the €400 million criteria within the perimeter).

The documentation – corresponding to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European commission must include: (i) general information about the group and its subsidiaries (master file) and (ii) detailed information on the French audited company (description of its activities and transactions, including a presentation of the applied transfer pricing method) (country specific file).

If the company fails to provide the documentation, a fine of €10,000, or 5% of the adjusted profits (the actual rate depends on the behavior of the company), whichever is higher may apply.

For companies not subject to the mandatory T.P. documentation, Tax authorities may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company and details of the activities of the nonresident affiliated companies and the tax regime applicable to them.

In order to avoid uncertainty, taxpayers may want to reach an advance transfer pricing agreement with the French tax authorities. The advance pricing agreement could be unilateral, bilateral or multilateral. The French program proves to be efficient and pragmatic.

v. N.C.C.T.

Article 238-0 A of the F provides for a 50% levy on all types of payments on accounts open in an N.C.C.T. from the 1st march of 2010. This levy was increased to 55% for dividend payments made in these countries or territories. The criterion is the place where the money is transferred to, regardless of the beneficiary's State of residence. For example, payments made by a French debtor to the benefit of an N.C.C.T. resident is not subjected to the 50% or 55% withholding tax if the money is wired from France to an account open in a jurisdiction that is not qualified as an N.C.C.T. Conversely, if the payment is made by a French resident to a non N.C.C.T. resident via an account open in an N.C.C.T., the 50% or 55% withholding tax applies.

For the royalties, this rule applies in case of a payment made to a person domiciled in an N.C.C.T.

vi. Financial Transaction Tax ("F.T.T.")

Introduced by the former French president Nicolas Sarkozy as a push to an E.U.-wide tax (which is still being discussed), the F.T.T. imposes a participation of the financial industry into the restoration of the public accounts. This 0.1% tax would apply to acquisitions of listed stock issued by companies whose legal seat is in France with a market capitalization above €1 billion on January 1 of the year during which the acquisitions take place.[58]

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[58] This could affect about 100 French companies.

Taxable transactions would involve French-issued equity securities as defined above, but also securities that may give rise to equity rights (for example, preferred stocks, convertible bonds and any other bonds that may give rise to equity rights) with some exclusions covering for instance convertible bonds.

Although it still must be clarified, it seems that the acquisition of options, futures, and convertible bonds on eligible stocks may be taxable with some exemptions on convertible bonds. With the tax due at the time the stock is delivered at maturity (if not issued by the company), double taxation may arise.

The F.T.T. may also apply to instruments equivalent to the French listed stock or stock rights even if issued by another issuer under a foreign law (for example, American depository receipts).

The term "acquisition" includes a transfer of ownership through a purchase, exchange, contribution, or the exercise of an option, or through a futures contract.

To be subject to the F.T.T., the stock or equivalent instruments would be negotiable on a regulated market in France or the European Economic Area or on some limited non-E.U. regulated markets such as in Switzerland (Bourse Suisse) and Montreal (Bourse de Montreal Inc.). The N.Y.S.E. is not included. Stocks listed on a multilateral trading system are also outside the scope of the tax.

Guidelines should be issued by the authorities.

vii. <u>Transfer Taxes</u>

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares:

- Until July 31, 2012, transfers of stock issued by French SA, SCA or SAS except if they qualify as real-estate holding companies for tax purposes are subject to a progressive transfer tax rate of (i) 3% for the fraction of the price below €200,000, (ii) 0.5% for the fraction between €200,000 and €500 million and (iii) 0.25% for the fraction exceeding €500 million. As from August 1, 2012, a fixed tax rate of 0.1% would apply;

- Transfers of units issued by French partnerships, the capital of which is not divided into stocks except if they qualify as real-estate holding entities for tax purposes are subject to a fixed transfer tax rate of 3%. A relief equal to €23,000 divided by the total number of units issued by the entity is applied to the taxable value of each unit.

- Transfers of shares issued by French real–estate holding companies – irrespective of their legal form – are subject to a 5% transfer tax. As of January 1, 2012, transfer taxes applied to transfers of shares issued by real-estate holding companies are determined on the basis of the fair market value of the assets reduced by the sole acquisition debt related to real-estate assets.

Regarding the sale of assets, the following rates generally apply:

- 5.09% for transfers of real-property assets located in France (in some cases, such transfers may be subject to V.A.T. instead),

- A progressive tax rate for transfers of business as going-concerns ("*Fonds de commerce*") or goodwill: 0% for the fraction of the transfer price below €23,000, 3% for the fraction between €23,000 and €200,000 and 5% for the fraction exceeding €200,000.

12. Italy

A. Corporate Tax Rate

An Italian resident holding company is subject, as all the other kinds of companies, to corporate income tax ("I.R.E.S."), as ruled by the Income Tax Code (Presidential Decree dated December 22, 1986, n. 917 ("I.T.C."). Income tax is levied on the worldwide income of the company at a 27.5% flat rate.

A regional tax on productive activities ("I.R.A.P."), as ruled by Legislative Decree dated December 15, 1997, n. 446, also applies to the net value of the production realized in Italy, at rates ranging from 3.9% to 4.9%. Higher rates are applicable to banks and other financial institutions (4.65%) and to insurance companies (5.90%). See Article 16 of Legislative Decree n. 446 of December 15, 1997 as amended by Article 23 (5) of Law Decree n. 98 of July 6, 2011.

B. Dividend Exemption

i. Domestic Dividends

In general, the I.T.C. provides for a 95% exemption with regard to the receipt of a distribution from a domestic Italian company and no withholding tax is imposed. See art. 89 (2), I.T.C. The effective tax rate is thus 1.375% (0.05 x 0.275 = 0.01375). There are no minimum ownership or holding period requirements.

For companies adopting I.A.S./I.F.R.S. accounting, the receipt of profits arising from shares or other financial assets qualified as "held for trading" is fully taxed. (See art. 89 (2-*bis*) I.T.C.) It is also worth noting that companies adopting I.A.S./I.F.R.S. accounting must determine the positive and negative components of their tax base according to the criteria provided for by the accounting standards, which, in principle, prevail over the ordinary I.T.C. rules.

ii. Foreign Dividends

According to art. 89 (3), I.T.C., the 95% exemption applies also to foreign source dividends, provided that the payment is not deductible by the payer in its country of residence (the non-deductibility must be stated by the foreign company in a declaration or must result from other objective evidence).

If the dividends are directly or indirectly distributed by a company resident in a "black list" country or territory (qualified as privileged tax regime for controlled foreign company purposes), the exemption does not apply and, unless a favorable ruling is obtained from the Italian tax authorities, the entire amount of the dividend is taxed.

Dividends corresponding to profits already taxed in the hands of an Italian resident controlling company under the C.F.C. rules are not taxed again upon actual receipt. (See also Paragraph G, below.)

C. **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 art. 87, I.T.C., the exemption applies to the disposal of participations in both Italian and foreign subsidiaries.

The exemption applies if several conditions are met. First, the shares must be held for an uninterrupted period of twelve months prior to the disposal. In measuring the holding period where shares of stock have been acquired over time, a Last-In, First-Out rule applies. Direct tracing is not permitted. Second, the participation must be classified as a financial fixed asset in the first balance sheet of the shareholder covering the start of the holding period for the shares. Third, the tax residence of the subsidiary must be in Italy or in a jurisdiction that is not blacklisted for C.F.C. purposes (see also Paragraph G, below) during the three financial years preceding the year of the disposal of the participation. If the company is resident in a blacklisted jurisdiction but was formed to carry out active business operations, the shareholder may request a ruling from the Italian tax authorities proving that the purpose of the investment was not to obtain the benefits of a preferential tax regime. Finally, the subsidiary must carry on an active business (unless its shares are traded on a stock exchange) at least since the beginning of the third financial year preceding the sale of the participation.

Several rules apply to the foregoing tests. Under anti-avoidance rule, the company is deemed not to carry on an active business and cannot meet the active business test where real estate is the predominant asset reported in the company's balance sheet. Where the subsidiary is a holding company, the law requires that the final two conditions (residence and business) must be applied at the level of the operating companies owned by the holding company.

Where the participation exemption applies to a gain, only a portion of costs related to the sale is deductible. The percentage that is deductible is equal to the percentage of the gain that is taxable, *viz.*, 5%. See art. 86 (2), I.T.C.

D. **Interest Deduction**

Finance Act 2008 has completely redefined the regime of interest deduction for companies subject to I.R.E.S.

The new regime (see new art. 96, I.T.C.), in general, provides that:

- Interest expense is fully deductible in each tax period for an amount equal to interest income;

- The excess amount of interest expense can be deducted but the deduction is subject to a cap of 30% of an amount substantially corresponding to the E.B.I.T.D.A., as measured in the borrower's profit & loss statement;

- The amount of interest expense exceeding the 30% limit that is not deductible in the tax period incurred may be carried forward indefinitely until absorbed in a year when sufficient E.B.I.T.D.A. exists;

- Starting from 2010, the excess E.B.I.T.D.A. generated in each fiscal year will be carried forward and used to increase the E.B.I.T.D.A. of the following periods.

While banks and insurance companies, together with their holding companies and some other financial institutions, have been excluded, the regime of interest deduction applies to so-called "industrial holding companies", *i.e.*, those companies whose main business consists of holding participations in other businesses rather than being engaged in lending activities or the provision of financial services. See art. 96 (5), I.T.C. These holding companies are likely to be penalized by the new provisions, although if they participate in a domestic consolidation rules (see Paragraph F, excess interest expense of the holding company can be used to reduce the consolidated tax base generated by other consolidated companies. This rule applies also in the case of interest expense carried forward by a company, provided they have been generated during the period of fiscal consolidation. Note that in some circumstances the E.B.I.T.D.A. generated by certain nonresident controlled subsidiaries may be taken into account even though foreign subsidiaries are not permitted in an Italian domestic consolidation.

Specific rules are applicable for banks and insurance companies.

E. <u>Minimum Taxable Income for Non-operating Companies</u>

A particular anti-avoidance rule applies to non-operating companies and non-operating permanent establishments in Italy. Under art. 30 of the Law dated December 23, 1994, n. 724, an entity is deemed to be non-operating when the sum of its turnover, increases in inventory, and revenue reported on its profit and loss is lower than a specified base. The base is the sum of the following items: (i) 2% of the total value of participations in resident and nonresident companies, bonds and other financial instruments (ii) 4%-6% of the value of real estate and ships owned or leased by the company, and (iii) 15% of the value of other fixed assets. The calculation is made on the average values of those amounts over a three-year period (*i.e.*, the tax period concerned and the two preceding ones).

When a company is a non-operating company under the foregoing definition, it is taxed at a 38% rate on minimum income, calculated by applying a deemed return to the assets mentioned above. The deemed returns are (a) 1.50% of participations and other financial instruments, (b) 4.75% of real estate values (subject to a 3% rate for particular real estate assets), and (c) 12% of other fixed assets.

A non-operating company may demonstrate that specific facts and circumstances prevented it from achieving the minimum turnover. A ruling is required by the Italian tax authorities in order

to come within this exception. The law also provides some causes of automatic exclusion from the scope of the application of the general rule. Finance Act 2008 has increased the number of these exclusions and some of the most important are those provided for: (1) companies in the first year of activity; (2) companies whose share are traded on a stock exchange (and their subsidiaries and controlling shareholder); (3) companies which have had at least ten employees in the two preceding fiscal periods; (4) companies whose value of production, as measured in the profit & loss statement, is greater than the total value of assets reported in the balance sheet; (5) companies holding participations in subsidiaries that are considered to be "operating" companies or that have obtained a positive ruling; and (6) companies in insolvency proceedings.

After the amendments made by Article 2 of Law Decree n. 138 of August 13, 2011, the foregoing provisions are also applicable to companies that have (i) incurred fiscal losses for at least three consecutive tax years or (ii) incurred fiscal losses for two out of the three years of assessment and in the third year have reported income that is lower than the minimum income determined in the manner described above. Starting from the fourth consecutive tax year, those companies will be deemed to be non-operating companies even though they do not meet the usual requirements provided by Article 30 (1) of the Law dated December 23, 1994, n. 724.

F. <u>Group Consolidation</u>

After the introduction of the participation exemption regime, holding companies cannot reduce income by unrealized losses in participations. However, group consolidation is permitted. See art. 117-129, I.T.C. Two consolidation regimes exist. One is known as the domestic regime and the other is the foreign regime.

i. <u>Domestic Consolidation</u>

For the purposes of the domestic consolidation regime, a group of companies is constituted by a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two facts exist. First, the common parent must directly or indirectly have the majority of voting rights at the subsidiary's general shareholders' meeting. Second, the common parent must directly or indirectly hold more than 50% of the subsidiary's shares and be entitled to more than 50% of the subsidiary's profits.

A nonresident company may participate in the domestic consolidation as the common parent of the group, and only in limited circumstances. First, it must be a resident in a country that has a tax treaty in effect with Italy. Second, it must carry on business activity in Italy through a permanent establishment and the participations in the controlled subsidiaries must be recorded in the books of the permanent establishment.

The domestic consolidation tax regime applies only when an election is made by the common parent and the participating controlled subsidiaries. Not all subsidiaries are required to participate in the regime. Once made, the domestic consolidation regime is effective for three tax periods. If the requisite degree of control in a subsidiary is relinquished during this period, that subsidiary no longer participates.

The domestic consolidation tax 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 entire taxable income or loss of each controlled subsidiary is taken into account regardless of the percentage held by the common parent.

Domestic consolidated groups can take advantage of a rule that allows E.B.I.T.D.A. and interest expense to be computed on a consolidated basis. In addition, the E.B.I.T.D.A. of certain controlled foreign subsidiaries may be taken into account in computing the consolidated ceiling even though foreign subsidiaries are excluded from the domestic fiscal consolidation.

A separate limitation rule applies to losses incurred in 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.

ii. Worldwide Consolidation

In addition to the domestic regime, Italian law provides for a worldwide consolidation tax regime when an Italian resident company controls one or more nonresident companies. See art. 130-142, I.T.C. In order for a nonresident company to participate, its financial statements must be audited and an advance approval must be obtained from the Italian tax authorities.

Several differences exist between the domestic consolidation regime and the international regime. First, the international regime is not selective among group members. The option must be exercised by all the nonresident controlled subsidiaries or none. In addition, the consolidation is proportional to the profit entitlement of the common parent in each nonresident controlled subsidiary. It is believed that the option for worldwide consolidation has been exercised only by few Italian groups of companies.

G. C.F.C. Legislation

Italian tax law contains a C.F.C. regime applicable to individuals and companies that control, directly or indirectly, companies or other entities resident in countries or territories characterized by a privileged tax regime. See art. 167, I.T.C. Those countries and territories have been identified according to certain identified factors, most importantly a noticeably lower level of taxation in comparison to the Italian tax burden and the absence of an adequate procedure for the exchange of information. These jurisdictions are listed in the Ministerial Decree dated November 21, 2001 (the so called "black list"). Finance Act 2008 has planned to substitute the black list with a new "white list." (See *also* next Paragraph H of this chapter.)

For purposes of the C.F.C. regime, control is defined according to the Italian Civil Code. See art. 2359 of the Civil Code. A company is deemed to be controlled in one of three circumstances. The first is that the Italian resident holds, directly or indirectly, the majority of the voting rights exercised at the general shareholders' meeting of the company. The second test is that the Italian resident holds, directly or indirectly, sufficient votes to exert a decisive influence in the shareholders' meeting of the company. Finally, control may exist where the Italian resident exercises a dominant influence over the company by virtue of contractual relationships.

In order to avoid the application of the C.F.C. regime, an Italian resident company may request a ruling from the tax authorities giving evidence (i) that the nonresident company carries out an effective industrial or commercial business activity in the market/territory of the country where it is located; or (ii) that the Italian company does not benefit from a diversion of income into a privileged tax regime.

Concerning the condition sub (i), the Law Decree n. 78/2009 introduced the following changes:

- With respect to banking, financial and insurance activities, the condition is deemed to be met when the main portion of the respective sources, investments and proceeds originate in the state or territory where the foreign company is located;

- The condition is never met when more than 50% of the foreign company's proceeds is derived from (i) the management, holding or investment in securities, shares, receivables or other financial assets; (ii) the transfer or grant of right to use intangible rights on industrial, literary or artistic property; or (iii) the supply of services, including the financial ones, within the group. See art. 167 (5-*bis*).

The above mentioned Law Decree n. 78/2009 has also broadened the scope of the C.F.C. rules to involve controlled companies located in states or territories different from those included in the black list, if the following conditions are both met:

- The controlled foreign company is subject to an actual taxation that is more than 50% lower than the tax that would have been levied if it were resident in Italy; and

- More than 50% of the proceeds of the controlled foreign company are derived from the management, holding or investment in securities, shares, receivables or other financial assets, from the disposal or licensing of intellectual property rights, or from the performance of intra-group services. See art. 167 (8-*bis*).

Also in this case it is provided for a special safeguard clause pursuant to which the C.F.C. rules will not be applicable notwithstanding that the company meets the conditions outlined above. The resident shareholder can in fact demonstrate, by applying for an advance tax ruling, that the localization abroad does not constitute an artificial scheme aimed at achieving undue tax advantages. See art. 167 (8-*ter*).

If the C.F.C. rules apply, the profits of the C.F.C. are deemed to be the profits of the Italian resident. These profits are taxed separately at the average tax rate of the Italian resident, which is 27.5% for corporations.

Italian law contains a previously taxed income concept. As a result, when profits that were previously attributed to the resident company are distributed in the form of a dividend, the dividend does not constitute taxable income upon receipt.

H. The New "White-List" of Countries and Territories

Finance Act 2008 has replaced the "black list" of countries and territories characterized by a privileged tax regime (compiled for C.F.C. purposes) with a new list of countries and territories that will be selected by taking into account the presence of an adequate exchange of information between tax authorities and a level of taxation not significantly lower than the level in Italy. This is the so called "White List" regime. The C.F.C. rules and all the other I.T.C. rules relating to the "black list" (including the dividend and participation exemption regimes) have been modified to reflect the change. However, the amendment still has not entered into force, as the new White List will be applicable only from the tax period following its date of publication. As of May 2013, the list has not been published. For this reason, the black list remains in force in 2013.

I. Treaty Protection

Italy has concluded Tax Treaties with about 90 jurisdictions, including the more important developed countries and trading partners. In general, the treaties provide for reduced withholding tax rates, in line with the O.E.C.D. Model Treaty. Notable exceptions exist for withholding tax on interest. In the new treaty with the U.S., the withholding tax rate is 10%.

J. Withholding Taxes on Outbound Payments

i. Dividend Withholding – Domestic Law

In general, Italian law provides that dividends distributed by Italian companies are subject to a 20% withholding tax. The rate may be reduced to 11% for dividends paid out to pension funds established in E.U. Member States or E.E.S. Countries (*i.e.,* Iceland, Liechtenstein and Norway) are included in the White List. The recipient can claim a refund up to one fourth for the withholding tax suffered if taxes have been paid on the same income in its country of residence. This is provided in art. 27 (3) of Presidential Decree n. 600/1973. If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.

For dividends distributed to companies or other entities resident and subject to income tax in E.U. Member States or in the above mentioned E.E.S. Countries included in the White List, a reduced 1.375% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions to domestic companies. (See Paragraph B above.)

If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are treated as described above (they are subject to a 95% exemption).

ii. Parent/Subsidiary Directive

Under the Parent/Subsidiary Directive implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may claim a refund of the 20% or 1.375% withholding tax levied on dividends distributed by Italian subsidiaries. After the amendments brought by Directive 2003/123/CE, as implemented in Italy by Legislative Decree dated February 6, 2007, n. 49, the required minimum direct shareholding in the Italian company is reduced to 10%.

In order for a company to qualify as a parent for the benefit of the Parent/Subsidiary Directive, it must meet certain requirements. First, it must have one of the corporate forms listed in the Directive. Second, it must reside for tax purposes in an E.U. Member State. For this purpose, a company that is a dual resident company, and that under an income tax treaty has its residence allocated to a jurisdiction outside the E.U., is not considered to be a resident of an E.U. Member State. Third, it must be subject to one of the income tax regimes listed in the Directive without the possibility of opting for favorable regimes or exemptions. Finally, it must have held the participation for an uninterrupted period of at least one year.

To demonstrate compliance with the first three conditions, a certificate issued by a foreign tax authority must be submitted. The last condition is corroborated by a declaration.

Once the conditions have been met, the exemption is mandatory.

iii. Interest and Royalties

Italy has implemented the Interest and Royalties Directive on payments made between associated companies of different E.U. Member States. See art. 26-*quater*, Presidential Decree n. 600/1973. Payments of interest and royalties made to associated companies resident in other Member States are exempt from withholding tax. The recipient of the payment must be an associated company resident in another Member State, having one of the corporate forms listed in annex to the Directive. Alternatively, it can be a permanent establishment of a Member State if the permanent establishment is located in another Member State.

Two companies are deemed to be associated under either of two tests. The first is that one of the companies holds directly at least 25% of the voting rights at the general shareholders' meeting of the other company. The second is that a third company resident in a Member State and having one of the corporate forms listed in the annex holds directly at least 25% of the voting rights in both companies. The requisite ownership must be held for at least one year.

Art. 23 (1) of Law Decree n. 98 of July 6, 2011 introduced a new 5% withholding tax applicable to interest paid to a nonresident that is not the beneficial owner of the payments, provided that (i) the interest payment is intended to finance the payment of interest and other proceeds on bonds issued by the recipient and (ii) the bonds are traded on an E.U. or E.E.S. regulated market. For more detail, see Article 26-quater (8-bis) and for the definition of "beneficial owner." See Article 26-*quater* (4), I.T.C.

iv. Nonresident Shareholder with a Permanent Establishment

Shareholders with a permanent establishment in Italy are taxed on the income of the permanent establishment. Income of the permanent establishment is determined under the same rules applicable to income of resident companies. This means that, if the shareholding is qualified, the participation exemption regime applies.

v. Nonresident Shareholder – No Permanent Establishment

Nonresident companies without a permanent establishment in Italy are taxed on their income produced in Italy under the same rules applicable to resident individuals. See art. 151 and art. 152 (2), I.T.C. In particular, they are deemed not to have business income.

Where the foreign corporation sells an interest in an Italian subsidiary, the tax treatment depends on whether the participation is qualified. Once the participation is qualified, according to art. 68 (3), I.T.C., 49.72% of the capital gain is included in taxable income and is subject to I.R.E.S. tax. If the participation is not qualified and the shares disposed of relate to a participation in a listed company, capital gains are deemed to be produced outside of Italy. *See* art. 23 (1) (f), I.T.C. If the participation is not qualified and the shares disposed of relate to a participation in a private company, capital gains are not taxed if the shareholder is resident in a country with an agreement calling for an adequate exchange of information with Italy. See art. 5 (5) (a), Legislative Decree dated November 21, 1997, n. 461. Finally, if the participation is not qualified and the shares disposed of relate to a participation in a private company, capital gains are subject to a 20% substitute tax if the shareholder is resident in a country without an adequate exchange of information agreement with Italy. *See* art. 5 (2), Legislative Decree n. 461/1997.

A participation in a listed company is deemed to be qualified if the total participation sold during a period of 12 months represents an amount that is greater than 2% of the company's voting rights or 5% of capital of the listed company. If the company is not listed, a participation is qualified if the total participation sold during a period of 12 months represents an amount that is greater than 20% of the company's voting rights or 25% of capital of the company.

These rules are subject to modification under an applicable treaty.

K. Foreign Tax Credit

A foreign tax credit is granted to avoid international double taxation. See art. 165, I.T.C. The tax credit is subject to a foreign tax credit, calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period. See art. 165 (6), I.T.C.

L. Allowance for Corporate Equity ("A.C.E.")

In order to encourage Companies to strengthen their financial structures by using equity rather than debt, Article 1 of Law Decree n. 201 of December 6, 2011 introduced the possibility to deduct from total net income a notional return on the increase in Equity that is derived from capital contributions and the like, rather than retention of earnings.

Ministerial Decree of March 14, 2012 (hereinafter "the Decree") contains the operative provisions of this rule. The A.C.E. provision is effective from the tax year in which December 31, 2011 falls. The benefit may be claimed by:

- Companies resident in Italy, as indicated by Article 73 (1), lett. a) of I.T.C.;

- State and private entities other than companies, as well as trusts resident in Italy, whose main or exclusive object is the carrying out of a commercial activity, as indicated by Article 73 (1), lett. b) of I.T.C.;

- Italian permanent establishments of non-Italian-resident companies and entities, as indicated by Article 73 (1), lett. d) of I.T.C.;

- Individuals, S.N.C.s, and S.A.'s. regulated by ordinary accounting rules.

The notional return 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 a tax period over the Equity book value at the end of the previous tax period. The increase in Equity book value attributable to the increase in retained earnings for the year is not taken into account. See Article 2 (1) of the Decree.

In order to determine the net increase in Equity, Article 5 (2) of the Decree provides the following items are to 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;

- Income accumulated, with the exception of income accumulated to non-available reserves (see Art. 5 (5) for the definition of "non-available reserves").

The increases in any particular tax year cannot exceed the value of the net Equity at the end of that tax year. See Article 11 of the Decree.

In computing the net increase in Equity, Article 5 (3) of the Decree provides that decreases in Equity through any type of distributions to shareholders must be taken into account (for instance, through dividend distributions or Equity reductions).

Once the increase is computed, Article 3 of the Decree provides that for the tax year of December 31, 2011 and the following two tax years, a deduction is allowed for 3% of the increase. In following tax years, the percentage will be determined by Decree of the Minister of Economy and Finance, to be issued by January 31st, following the close of the tax year.

Specific rules are provided for companies participating in a Group Consolidation (see Article 6 of the Decree) and for companies who opt for the "transparency regime" under Articles 115 and 116 of I.T.C. (see Article 7 of the Decree).

Finally, Article 10 (3) of the Decree provides specific anti-avoidance rules, especially for companies belonging to a Group.

13. GERMANY

A. Introduction

During the last years, several steps have been taken to make Germany a more attractive place for holding companies - especially within the European Union. On the other hand, there have been efforts to prevent international businesses from using international financing structures with the aim to have interest paid to shareholders as business expenses in Germany but leave the profits of the actual operating business taxable in tax havens. The advantages of Germany as an investment location may not only be judged by the tax rate: whereas the basis corporate tax rate of 15% seems to be very attractive, the effective tax rate ranges at about 30% because the trade tax burden must be added to get the effective tax rate. Nevertheless the preferred treatment of dividends received from other companies and capital gains from selling participations, as well as the exemption from dividend withholding tax for dividends paid to companies located in other European member states have created at least a competitive tax environment for investments in Germany. This is even more interesting as the German economy has not suffered from the worldwide financial crisis as strong as the other European economies. So, Germany is an interesting location not only for holding companies but also for active investments. In addition, Germany has one of the largest tax treaty networks with only few countries not covered as for example Brazil and Saudi Arabia.

B. General Taxation of German Corporate Entities

A German holding company is subject to corporate tax and trade tax. The regular corporate tax rate is 15% (plus 5.5% solidarity surcharge on the corporate tax liability). On top of the corporate tax trade tax has to be paid by most of the companies. Trade tax is a municipal tax and the final tax rate is determined by each municipality, which leads to an effective trade tax rate between 7 % and 17% (average: 14 %). Therefore, the effective tax burden for a corporate entity is about 30%. It should be mentioned that there is a 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 but with certain adjustments especially for the definition of income taxable under the Trade Tax Act.

C. General participation and Dividend Exemption

i. Background

In Germany, corporate tax is levied on the profit of a corporation as computed in the company's commercial balance sheet but adjusted for tax purposes. There is no difference in the treatment of distributed or retained profits.

Dividends and capital gains received from other corporations within or outside Germany are basically exempt from German corporate tax. However, 5% of these dividends or capital gains

are treated as non-deductible expenses so there is an effective tax of less than 2% on these profits.

The corporation is obliged to retain withholding tax on dividends paid to shareholders at a rate of 25% (plus solidarity surcharge). This withholding tax (“*Kapitalertragsteuer”*) is credited in full against the individual tax liability of the recipient. As the final tax rate on dividend income and capital rate gains for individuals is a flat tax rate - irrespective of their individual tax rate - , no further tax becomes due. In case of business income, 40% of the income deriving from dividends and capital gains are 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.

ii. Participation Exemption

The participation exemption of 95% for capital gains applies to 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 also includes profits from recaptures and profits from hidden profit distributions upon a sale of shares below fair market value. The participation exemption also applies when the participation is held directly or indirectly through a partnership. This may be the case, when corporation A disposes of a share in a partnership that owns shares in corporation B or when the partnership itself disposes of the participation.[59] The participation exemption in partnership structures applies for trade tax purposes as well.

However, there are exception rules regarding the 95% participation. The most important exceptions to tax-free treatment 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.[60]

- The exemption does not apply when shares are held by a company engaged in financial business (“*Finanzunternehmen*”) and the shares were acquired with the intent to realize a short-term profit.[61] According to the tax courts, companies mainly engaged in holding activities may fall under this provision.[62]

- A general exception from the 95% participation exemption exists for banks, financial institutions, as well as for life and health insurance companies.

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59 Sec. 8b, para. 6 C.I.T.A.

60 Sec. 8b, para. 2, sent. 4 C.I.T.A.

61 Sec. 8b, para. 7, sent. 2 C.I.T.A.

62 Judgment of the Federal Tax Court dated January 14, 2009.

Reductions in profits arising in connection with corporate stock holdings (in particular, extraordinary write-downs) are disregarded in determining taxable income. This exception also applies to shareholder debt under the following prerequisites:

- Reductions in profits in connection with a loan (*e.g.* write downs to going concern value, forgiveness of the unrecoverable portion of a debt claim),
- Reductions in profits in connection with securities and guarantees given for a loan, and
- Reductions in profits resulting from legal acts that are the economic equivalent of a loan.

This provision applies to loans made or security posted, by (i) substantial shareholders (shareholders holding more than 25% of share capital either directly or indirectly), (ii) persons related to substantial shareholders, and (iii) third parties with a right of recourse against the aforementioned persons. The statute would apply even if the shareholder is no longer a substantial shareholder at the time of the reduction in profits, but previously held such status. The denial of a deduction does not apply if it is shown that an unrelated third party would also have made the loan under the same circumstances or would not have required its repayment (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.

iii. Dividend Exemption

The dividend exemption applies to dividends received both from domestic and from foreign participations.[63] For corporate tax purposes, it does not depend on any holding period and does not require any minimum participation.

The dividend exemption applies as well for trade tax purposes, if a participation of at least 15% has been held at the beginning of the tax year. In case of foreign dividends received, a participation of at least 15% has to be held for an uninterrupted period since the beginning of the tax year and the foreign company has to pass an activity test. For participations in E.U. subsidiaries a participation of 10% qualifies for the dividend exemption and no activity test is required.

Similar to the 95% participation exemption, the dividend exemption is limited to 95% of the dividend received as 5% of all dividends received are deemed to be nondeductible expenses. In principle, this applies regardless of the amount of the effective business expenses related to the dividend.

iv. Financing Expenses

Despite the capital gains and dividend exemption, financing costs relating to the acquisition of shares are, in principle, fully tax deductible for corporate tax purposes, within the limitations of

[63] Sec. 8b, para. 1 C.I.T.A.

the earning stripping rules (see Paragraph E of this chapter below). This is an exception to the general rule of German tax law that business expenses incurred in relation to tax-exempt income (*i.e.* dividends or capital gains) are not tax deductible.[64]

A different rule is applicable for trade tax purposes. When computing trade tax income, 25% of the interest on debt is added back to the tax base.

D. Trade Tax Add-Backs and Deductions

The income computed for corporate tax purposes is adjusted for trade tax purposes by various add-backs and deductions.

The add-backs include one-fourth of the sum (exceeding €100,000) of the following items:

- Loan remuneration (*e.g.* interest),
- Recurring payments,
- Profit shares of a silent partner,
- 20% of rental and leasing payments for moveable fixed assets,,
- 65% of rental and leasing payment for immoveable fixed assets,
- 25% of payments to obtain license rights for a limited time period, except for licenses that merely confer entitlement to license to third parties the rights derived there under.

The additional deductions include:

- 1.2% of 140% of the assessed value ("*Einheitswert"*) of real property,
- 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% (10% in case the E.U. Parent/Subsidiary Directive is applicable) since the beginning of the tax year, provided this corporation (almost exclusively) generates active income. However, the active business requirement is not applicable with respect to companies resident in an E.U. Member State.

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64 Sec. 3c, para. 1 Income Tax Act ("I.T.A.").

E. Earnings Stripping Rules

i. General Concept

Within the 2008 Business Tax Reform Act, earnings stripping rules were introduced to the German income tax law replacing the former thin capitalization rules.[65] The earnings stripping rules apply in general to all types of debt financing of sole entrepreneurships, partnerships and corporations. The scope of the rules is far broader than the former thin capitalization rules as any third party debt financing (whether or not there is a 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 equal 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. (interest deduction ceiling).

Tax E.B.I.T.D.A. is defined as taxable profit before application of the interest deduction ceiling, increased by interest expenses and by fiscal depreciation and amortization and reduced by interest earnings.

For purposes of the earnings stripping rules, the controlling company and the controlled companies of a tax group are treated as a single entity. Thus, the earnings stripping rules are not applicable at the level of the controlled company. The interest expense and interest revenue of the controlled company and the controlling company are aggregated.

Nondeductible interest expenses in a considered period may be carried forward (interest carry-forward). They increase the interest expenses in the following year, but they are not taken into account to determine the tax E.B.I.T.D.A. On the other hand, any tax E.B.I.T.D.A. amount that is not consumed by interest expenses for the purposes of the earnings stripping rules may also be carried forward (E.B.I.T.D.A. carry-forward).

ii. Exemptions

The earnings stripping rules do not apply provided that interest expense exceeds positive interest income by less than €3 m. (tax threshold). Thus, small and medium business enterprises are generally exempt from the scope of the earnings stripping rules.

The earnings stripping rules also do not apply to businesses that are not members of a controlled group. A business is regarded as part of a controlled group if it is or at least may be included in consolidated financial statements in accordance with I.F.R.S., E.U. G.A.A.P. (G.A.A.P. of an E.U. member state), or U.S. G.A.A.P. principles. Consolidated financial statements in principle have to be drawn up in accordance with I.F.R.S. Consolidated financial statements in accordance with any E.U.-G.A.A.P. can be used if there is no obligation to prepare I.F.R.S. consolidated financial statements and no I.F.R.S. consolidated financial statements have been prepared in the five preceding years. Consolidated financial statements in accordance with U.S. G.A.A.P. can be used if there is neither an obligation to prepare I.F.R.S. consolidated financial statements nor consolidated financial statements according to the G.A.A.P. of any E.U. member state.

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65 Sec 4h I.T.A., Sec 8a C.I.T.A.

Furthermore, there is an escape clause for businesses that are part of a controlled group. Provided that the equity ratio of the entity in question is equal or higher than the equity ratio of the controlled group, the earnings stripping rules does not apply. There is a 2% safety cushion for the equity ratio of the business in question. As a consequence, the escape clause is still met when the equity ratio of the entity is 48% and the equity ratio of the controlled group is 50%. The calculation of the equity percentage of the business must be based on the values of the assets and liabilities as reflected in the consolidated financial statements.

The exemption for non-controlled corporations and the escape clause applies only if the corporation establishes that remuneration on shareholder debts accounts for at most 10% of the net interest expense.[66] Shareholder debt is defined as debt that is granted by a substantial shareholder,[67] 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 detrimental.

F. Loss Carryforward

As a general rule, losses may be carried forward to the following fiscal years. The deduction of losses incurred in previous years is only limited by the so-called minimum-taxation rules.[68] According to these rules, losses may only be deducted from recent profits up to an amount of €1 million. Of the exceeding loss amount, only 60% may be deducted. The non-deductible 40% of the exceeding amount will again be carried forward.

However, in case of a transfer of more than 25% of the shares in a company within a time period of five years, the portion of the losses representing the transferred shares will be lost. If more than 50 % of the shares are transferred within five years, all of the loss carry forward will be excluded from deduction in the future.[69] This is a critical point when investing in companies, because the (oftentimes considerable) loss carry forward cannot be used after the acquisition of the target to compensate the profits resulting from financial restructuring measures.

G. 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. The C.F.C. rules apply if:

- More than 50% of the share capital or voting rights in the foreign corporation are held by taxpayers who are subject to unlimited tax liability in Germany;
- The foreign corporation generates so-called passive income; and

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66 Sec. 8a, para. 2 C.I.T.A.

67 Shareholder of more than 25 %.

68 Sec. 10b I.T.A.

69 Sec. 8c C.I.T.A.

- The foreign corporation is subject to low taxation, *i.e.* its effective tax burden determined according to German tax principles is below 25%.

Passive income is income that is not explicitly classified by the C.F.C. regulations as active. Classified active income includes income from manufacturing, trading, the provision of services, and some forms of licensing and renting, except for certain structures designed to reallocate taxable income from Germany to a tax haven. Dividends, constructive dividends and in principle capital gains are active income as well. The classification of capital gains as active income depends on the activity of the sold company.

Special rules apply for companies generating investment type income. 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 aforementioned conditions are fulfilled, passive income as determined under German tax legislation is apportioned to all German resident individual and corporate shareholders. The apportioned income is treated as a profit distribution received in the year following the year in which realized by the C.F.C. The German shareholder does not benefit from applicable treaty provisions and the general dividend exemption does not apply.[70]

Losses of the C.F.C. are not deductible by the German shareholder, but they may be carried forward or backward against profits of the C.F.C. to offset C.F.C. dividend income of the shareholder.

An exemption from the C.F.C. rules applies for a C.F.C. with its registered office or place of management in a member country of the European Union or European Economic Area provided the company carries on genuine economic activities in this country.[71] Genuine economic activities require a fully-fledged business with an appropriate office, employees and technical equipment. Generally, "genuine economic activities" are determined by the criteria stated by the European Court of Justice in the *Cadbury Schweppes* decision. Only such income that is attributable to the genuine economic activity, which is derived by that particular activity (and only insofar as the arm's length principle is observed) is exempt from the C.F.C. rules. This exemption was introduced in response to the European Court of Justice's *Cadbury Schweppes* decision.

H. Dividend Withholding Tax

A nonresident's dividend income is subject to withholding tax collected at the source. The statutory rate of German withholding tax is 25% (plus solidarity surcharge of 5.5%). Foreign corporations may claim a refund of two-fifths of the withholding tax (effective withholding tax

[70] Sec. 10 para. 2, sent. 3 Foreign Relations Taxation Act ("F.R.T.A.").

[71] Sec. 8 para. 2, Foreign Relations Taxation Act ("FRTA").

rate is 15% plus solidarity surcharge). In many cases, lower rates will be levied by virtue of 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 12 months. [72]

However, Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies and had changed these rules in order to avoid further requests for changes from European Commission.[73] A foreign company is denied a reduced withholding tax rate to the extent it is owned by persons who would not be entitled to a reduced rate if they would have derived the income directly and at least one of the following additional 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 would receive the dividends directly and

- The gross-income of the respective company in the respective fiscal year does not come from own business activities and

- There are no economic or other substantial reasons for involving that company or

The company has no business of its own set-up to take part in general business activities. The aforementioned anti-treaty-shopping rules nevertheless may still be held to be a violation of European law. The European Commission may still request the Federal Republic of Germany to amend the rules. If Germany fails to react to the formal request, the case may go before the E.C.J.

I. Transfer Pricing

i. German Administrative Principles

German tax authorities are empowered to adjust reported income from transactions between related parties that are carried out on a non-arm's length basis if the transfer price otherwise agreed upon by the parties would lead to lower taxable income in Germany.

The standard transfer pricing methods confirmed by the legislators are the comparable uncontrolled price method, the resale price method and the cost-plus-method. In practice, these standard methods may be extended to include other elements, such as global cost allocations. Under certain circumstances, profit-based global methods, such as the profit split method and the transactional net margin method are accepted by the German tax authorities, whereas the comparable-profit method is not accepted. A hypothetical arm's length test will be applied if it is

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72 Sec. 43b para. 2 I.T.A.

73 Sec. 50d, para. 3 I.T.A.

not possible to determine arm's length transfer prices on the basis of a recognized transfer pricing method.

It should be noted that, whether or not the requirements of the arm's length principle are met, business expenses in favor of majority shareholders are only tax deductible if the expenditures are made on the basis of clear and unambiguous agreements concluded in advance of the transaction. Charges made to German corporations without a clear and unambiguous advance agreement will be treated as a formal constructive dividend even if the transaction is carried out at arm's length.

ii. <u>Transfer of Functions</u>

As of 2008, provisions on the transfer of functions are included in the transfer pricing legislation. This means that a function is relocated abroad with the associated opportunities and risks, including the assets and other benefits are 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 issued an extensive legal decree ("*Funktionsverlagerungsverordnung*") in July 2008 and administrative guidelines with practical examples in October 2010. Documentation Requirements

Germany has introduced extensive rules regarding transfer pricing documentation and penalties. According to the rules, a German taxpayer must document the type of cross-border business transaction carried on 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 further been specified 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.

14. SWEDEN[74]

A. In General

Sweden has emerged as an attractive country for establishing financing and holding companies for both E.U. and non-E.U. corporations, however intra-group interest restrictions may affect this status negatively. The key features of the Swedish holding company regime are:

- A very favorable participation exemption regime for both dividends and capital gains;
- No thin capitalization rules;
- No withholding taxes on outbound interest payments;
- An extensive network of double tax treaties (more than 80 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains);
- Low corporate income tax rate (22%, 2013);
- Relatively low requirements on minimum share capital – SEK 50,000 (approx. €6,000); and
- No withholding tax on dividend distributions to qualified U.S. shareholders (minimum holding 80% of the votes, minimum holding period 12 months) or 5% withholding tax for holdings amounting to 10% or more of the votes (no required holding period).

The main legal entity used for holding and financing purposes is the 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 is also a legal entity for tax purposes. An A.B. is also a qualifying entity under the Swedish participation exemption.

B. Participation exemption

i. General

The net income of a Swedish company is normally subject to corporate income tax at a rate of 22%. However, if both the holding company and the subsidiary are qualifying entities under the participation exemption, income from capital gains and dividends are tax exempt. According to the Swedish Income Tax Act ("I.T.A."), Chap. 24, the holding entity must be in one of the following entities in order to qualify:

- A Swedish A.B. or a Swedish economic association that is not an investment company;

[74] The author acknowledges the contribution of Daniel Gustafsson of Delphi Law Firm, Gothenburg, in the preparation of this portion of the article.

- A Swedish foundation or a Swedish non-profit association that is not subject to tax exemption according to Chap. 7 I.T.A.;
- A Swedish savings bank;
- A Swedish mutual insurance company; or
- A "foreign company" resident within the E.E.A. which 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 which is subject to tax in its country of residence if the taxation is similar to the taxation of a Swedish AB. According to the preparatory works, a tax rate of approximately 14% (60% of 22%) is acceptable. Also, a foreign legal entity resident in a state 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. or an economic association (or a similar foreign entity, see section iv. below). The share must also be a capital asset (*e.g.* other assets than trading stock, inventory, work-in-progress, receivables and similar assets, equipment, patents and other intangibles). Additionally, it must meet any of the following criteria:

- The share is not listed;
- The holding entity owns shares representing at least 10% of the total number of votes of the company; or
- The holding is deemed necessary for the business conducted by the owner or any other company within the community of interest 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.

ii. 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.

iii. Capital Gain

Capital gains on the disposal of business-related shares are tax exempt. Accordingly, a capital loss deriving from the disposal of those shares is not deductible. If the shares are listed, the

capital gain is tax exempt provided the shares have been business-related for the seller during 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.

iv. 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 recent 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 of an O.O.O. to a Swedish limited liability company. In addition, the O.O.O. was subject to income tax in Russia. Therefore, it was deemed to correspond to a Swedish limited liability company. So far, a large number of foreign legal entities have been deemed to correspond with Swedish A.B.'s, by the Supreme Administrative Court and the Board for Advance Tax Rulings.

C. Withholding tax

i. Outbound Dividends

Under the Swedish Withholding Tax Act ("W.T.A."), a 30% withholding tax is levied upon distribution of dividend by a Swedish A.B. However, due to the implementation of the E.C. parent-subsidiary directive and Sweden´s extensive network of double tax treaties withholding tax will in most cases not be imposed, or imposed at a reduced rate. 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 persisted for at least a year. If the size of the holding is below 80% but amounts to 10% or more of the votes, the withholding tax rate is instead reduced to 5% of the gross amount distributed.

Dividends distributed to a legal entity resident within the E.U. are exempt from withholding tax if the recipient holds at least 10% of the share capital in the distributing company and fulfills the conditions set forth in art. 2 of the E.C. parent-subsidiary directive.

Also, if the shares in the distributing company are deemed business related under the participation exemption regime and the dividend (or capital gain at disposal of the shares) would have been tax exempt if the entity holding the shares had been a Swedish company, the dividend is exempt from withholding tax.

ii. Inbound Dividends

Withholding tax on distributions from foreign subsidiaries are often eliminated under the E.C. parent-subsidiary directive, or reduced under a double tax treaty. (See iii for treaty chart.)

iii. **Treaty Chart**

Sweden currently has over 80 double tax treaties in effect, with the following states:

Albania
Argentina
Australia
Austria
Bangladesh
Barbados
Belarus
Belgium
Bermuda
British Virgin Islands
Bolivia
Botswana
Brazil
Bulgaria
Canada
Cayman
Chile
China
Cyprus
Denmark
Egypt
Estonia
Finland
France
Gambia
Germany
Great Britain
Hong Kong
Iran
Ireland
Iceland
Israel
Italy
Jamaica
Japan
Canada
Kazakhstan
Mauritius
Mexico
Namibia
Norway
New Zeeland
Oman
Peru
Poland
Portugal
Romania
Russia
Switzerland
Singapore
Slovakia
Spain
Sri Lanka
South Africa
Taipei
Tanzania
Thailand
The Netherlands
The Philippines
The Czech Republic
The Faeroe Islands
Trinidad and Tobago
Tunisia
Turkey
Ukraine
Uruguay
Venezuela
Vietnam
Yugoslavia (Former)
Zambia
Zimbabwe

D. **Financing**

i. **Loan Financing**

As a general rule, all interest payments are deductible without limitation. Sweden does not impose withholding tax on interest payments. As there are no thin-capitalization rules (*i.e.* interest deductibility is not dependent on the fact that a certain debt/equity ratio is upheld) highly leveraged structures can be used.

From a transfer pricing perspective, the interest rates charged must be at arm's length. Interest rates charged between related parties that deviate from market conditions may be challenged by the Tax Agency.

Beginning January 1, 2013, a new regulation entered into effect that limits deductions for interest expense attributable to all loans from affiliated companies. Interest charged to the Swedish company will only qualify for tax deduction in cases where debt financing is in place for commercial reasons. This new regulation is a reaction to the seemingly widespread practice for

Swedish tax structures to reduce Swedish corporate taxation using intercompany loans from low tax jurisdictions.

ii. Equity Contributions

Under Swedish law, there are two types of shareholders' contributions available, conditional and unconditional contributions. An unconditional contribution is a final investment in the company, without a claim for repayment. An unconditional contribution is not deemed taxable income for the company, but it is indirectly a deductible expense for the contributor since the contribution is added to the tax basis of the shares and thus deductible when calculating the capital gain or loss on 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 not a taxable event, unless special circumstances are at hand.

Sweden does not impose any transfer tax or stamp duty on equity contributions.

E. Liquidation

i. 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, a shareholder is normally taxed for the difference between the amount distributed during the liquidation and his tax basis in the shares. If the shares are business related, no capital gain or loss will be recognized. For foreign shareholders, a distribution in connection with the liquidation of a company is deemed to be distribution of dividend. Thus, withholding tax will be levied on the distributed (gross) amount. If the company is dissolved within two years from the distribution, the shareholders acquisition value for the shares may be deducted by means of restitution of the amount of withholding tax paid that exceeds the tax imposed on an amount equal to the difference between the distributed amount and the acquisition value. However, as mentioned in Paragraph C of this chapter, withholding tax will in most cases be eliminated or imposed at a reduced rate.

ii. Losses

Final losses on liquidation of foreign subsidiaries can be utilized by means of a special group deduction ("*koncernavdrag*"). The following conditions must be met in order for a group deduction to be allowed:

- The foreign subsidiary has been liquidated;
- The foreign subsidiary has been wholly owned during the entire fiscal year of both the parent and the subsidiary until the end of the liquidation, or the

subsidiary has been wholly owned since it started conducting business of any kind until the end of the liquidation;

- The deduction of the group contribution is made in connection with the tax assessment of the fiscal year during which the liquidation has ended;

- The deduction of the group contribution is openly disclosed in the tax assessment of the parent company;

- There are no companies in community of interest with the parent company that after the end of the liquidation conducts business in the domicile state of the subsidiary.

A loss is considered final only if the subsidiary, or another person in the domicile state of the subsidiary, has not been able to utilize the loss and will not be able to utilize it in the future. If the loss is not utilized because the law of the domicile state does not provide for such a possibility or that such a possibility is limited in time, the loss will not be considered final.

There are also limitations as to the amount that may be deducted. The deduction may not exceed the loss of the foreign subsidiary by the end of the last whole fiscal year before the end of the liquidation or before the liquidation. The deduction may also 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 is disregarded if such a contribution has caused or increased the loss in the subsidiary.

F. Net Operating Losses

The result of a business is calculated as the difference between gross taxable income and allowed deductions. Net operating losses ("N.O.L.") can be utilized by means of carry forward. The N.O.L. is then forwarded to the next fiscal year, and is used as a deduction when calculating the result of the business. The possibility to utilize N.O.L.s from previous years is unlimited in time.

If a company acquires the controlling influence over another company with N.O.L.s from previous years, certain restrictions will apply regarding the use of the N.O.L.s.

First, losses exceeding 200% of the acquisition price will be forfeited. Second, the remaining losses cannot be utilized through group contributions from the acquiring company until after five fiscal years have passed after the year when the restriction entered into force.

The restrictions do not apply to group internal restructurings.

G. Transfer Pricing

Sweden applies a transfer pricing provision based on the O.E.C.D. arm's length principle. In practice, this means that prices charged between related parties must be set in accordance with market rates. If the taxable result of a Swedish company, because of internal pricing deviating from what would have been charged between independent parties, is lower than it would have been if market prices would have been charged the Tax Agency may challenge the taxable result.

Also, Swedish companies are required to keep documentation on cross-border transactions with related parties. As is the case in other countries, the Tax Agency has increased its focus on transfer pricing matters.

In order to avoid future conflicts with the Tax Agency regarding transfer pricing, it is possible to apply for a binding Advance Pricing Agreement ("A.P.A."). The fee for obtaining an A.P.A. is currently SEK 150,000 (approx. €19,000). The agreement is normally valid for 3-5 taxable years.

H. Controlled Foreign Corporation – C.F.C.

The purpose of the Swedish C.F.C. rules is to prevent Swedish persons or companies from deferring or avoiding taxation by collecting funds in a foreign subsidiary resident in a low tax jurisdiction. If a foreign subsidiary is deemed a C.F.C., a shareholder subject to tax in Sweden will be taxed directly for his share of the C.F.C.s profit – as calculated under Swedish G.A.A.P. and tax rules, irrespective of whether any funds have been distributed or not. Any tax paid in the foreign jurisdiction is creditable against Swedish tax.

In order for the C.F.C. rules to be applicable, the foreign corporation must be subject to low tax, which is defined as a tax rate lower than 55% of the Swedish corporate tax rate (*i.e.*, 12.1 %). The controller, *i.e.* the person subject to C.F.C. taxation, must own or control at least 25% of the capital or votes of the foreign corporation alone or together with persons in a community of interest with the controller.

There are two exceptions from the C.F.C. rules:

- First, regardless of the level of taxation, a foreign legal entity is not deemed a C.F.C. if it is resident for tax purposes in a country mentioned in a so-called "white list." If Sweden has concluded a double tax treaty with such a country, the aforementioned exception from the C.F.C.-rules is only applicable on income that falls within the scope of the treaty.

- Second, if the C.F.C. is resident for tax purposes within the E.E.A. and is deemed a "real establishment" from which a commercially motivated business is conducted, the C.F.C. rules are not applicable.

15. CYPRUS

A. General

For more than 25 years, Cyprus has been an active and well-structured international business center, catering to the requirements of international businessmen and business entities. However, the current financial crisis has seriously affected the Cyprus economy. The serious financial damage is limited to the depositors of the two largest Cyprus Banks:

- Laiki Bank Limited
- Bank of Cyprus Limited

Laiki is now under receivership because it has ceased to be solvent. Any amount over €100,000 is not secured, which means that these funds will remain under the jurisdiction of the Receiver who now has to collect all the loans that were classified as non-performing. When this process is complete, all depositors that have priority over other creditors will receive a certain percentage of their funds. This percentage will not be known until the total amount of loans that can be recovered by Receiver is determined. The secured deposits (amounts up to €100,000 per depositor) have been transferred to the Bank of Cyprus Limited which has been merged with the healthy part of Laiki Bank Limited. These deposits will be available in full at a time not yet identified.

The main consequence of the above described crisis is that most of our non-resident owned client companies have opened up operating bank accounts outside of Europe, as confidence in Europe as a whole has been shaken, or within Cyprus, at one of the many foreign banks in Cyprus.

The "resolution" of the Laiki Bank and reorganization of the Bank of Cyprus in such a manner as to downsize the banking sector in Cyprus, coupled with various revenue raising bills in order to meet the contributions that are part of the conditions of the European Commission, the European Central Bank and the International Monetary Fund so that a €10.0 billion aid package to Cyprus could be approved, could be seen to be within the general spirit of the B.E.P.S. report of the O.E.C.D. as well as the E.U.s drive to discourage base erosion tax planning.

The key factors contributing to the development of Cyprus as an international business base are:

- It's strategic geographic location.
- A favorable tax package with the lowest corporate tax in Europe.
- A well-developed double tax treaty network.
- Legal system and legislation based on English Law.
- The existence of an efficient, high level professional services sector.

The constitution of Cyprus and the international treaties ratified by Cyprus safeguard basic rights of legal entities and individuals.

The main tax provisions relating to Cyprus holding companies have not been touched. Cyprus has two revenue raising measures that must be considered when planning to use Cyprus as a base for a holding company. One is the income tax and the other is the defense levy. Each is discussed in turn.

B. Income Tax

Cyprus modified its corporate tax regime as part of the process of entering the E.U. The goal was to eliminate the special provisions applicable to offshore companies and to replace them with a system of tax based on a uniformly low rate for all corporations.

i. Tax Rate

The flat rate of 10% tax on annual net profit introduced and maintained since 2003, has now been revised and increased to 12.5% on net annual profits as from 2013.

ii. Residence

The concept of residency status for corporations was adopted in 2003, so that tax liability in Cyprus is dependent on the status of a company as a resident. This is determined by reference to the exercise of management and control in Cyprus. Although "management and control" is not defined, for a company to be considered a resident of Cyprus, the following tests are applied in practice:

- The majority of directors must be Cyprus residents;
- All policy decisions and major board meetings must be held in Cyprus; and
- Bank accounts and transactions should be conducted from Cyprus.

The existence of an actual physical location in Cyprus is taken into account, but is not absolutely necessary for residence to exist in Cyprus under Cypriot law. Nonetheless, a physical presence is helpful when a Cypriot company seeks relief under an income tax treaty with another country or with an E.U. member state.

iii. Permanent Establishment

Cyprus has adopted the general concept of the O.E.C.D. Model Treaty, including the "permanent establishment" concept. A permanent establishment is defined to include:

- A place of management,
- A branch,
- An office,
- A factory,
- A workshop,
- A building site or construction activities of more than three months.

iv. Income Subject to Tax

The general rule is that residents are taxed on worldwide income. However, several important exceptions apply to this rule. They may be summarized as follows:

- Profits from the activities of a permanent establishment outside Cyprus are exempt.

- Interest income derived from trading activities is subject to the flat 12.5% tax rate and this is the only tax payable for that type of interest income from ordinary trading activities. Interest income derived from investments attracts the Special Defense Levy, which is discussed below.

- Gains from trading in stocks and shares and securities generally are exempt from income tax for corporations. The definition of securities is structured so that holding companies in Cyprus dealing in securities have a broad exemption from Corporate Income Tax. The definition is discussed below. (See Paragraph B.v of this chapter, below.)

- Dividends received by a Cyprus holding company are exempt from income tax and no withholding tax is payable when dividends are paid by a Cyprus holding company to its nonresident shareholders.

- There is unilateral tax credit afforded in Cyprus for taxes withheld or paid in other countries where there is no bilateral agreement or Double Tax Treaty in force.

v. Expanded Definition of Securities

Pursuant to (ITL Section 8(22), the following instruments are considered to be securities for purposes of the exempt capital gains rules in Cyprus:

- Short position in titles;
- Rights of claim on bonds and debentures;
- Options on titles;
- Founders shares;
- Units in open-end and closed-end collective schemes;
- Index shares or Index bonds;
- Futures/forwards on titles;
- Preference shares;
- Swaps on titles;
- Repurchase agreements ("Repos") on titles;

- Depositary receipts on titles;
- Participation in companies; and
- Shares in L.L.C. companies registered in the U.S.

vi. Tax Losses - Group Relief

Tax losses can be set off without restriction against the profits of another company within a group of companies provided these are Cyprus tax resident companies. Group companies can consolidate results so that the losses of one company can be offset against the profits of another.

vii. Reorganization of Companies

The E.U. directive on mergers, acquisitions and spin-offs has been implemented in Cyprus. Consequently, mergers, divisions, transfer of assets, and exchanges of shares can be effected without the imposition of income tax. In addition, the losses of the target company may be transferred to the acquiring company provided that both companies are Cyprus tax residents and provided 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.

viii. Specific Income Tax Benefits

Certain types of income are subject to favorable tax treatments. These may be summarized as follows:

- Ship owning companies' income is tax exempt as well as V.A.T. exempt.

- Ship management income is subject to tax under the new Tonnage Tax legislation which reduces taxation to very low effective rates. However, there are specific conditions to be met for this to be implemented otherwise 12.5% corporate rate applies.

- Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the rate of 5% of the amounts paid. A similar rate of tax is imposed on film rental income derived by a nonresident.

- Royalties granted for the use of intellectual property rights outside Cyprus are not subject to withholding tax.

- Royalties granted for the use of intellectual property rights outside Cyprus to a Cyprus resident company are not subject to withholding tax and corporate income tax is applied only on the profit margin left in the Cyprus company.

ix. Specific Allowances and Deductions

Cyprus income tax law imposes few limitations on the ability of a corporation to deduct allowed expenses arriving at net annual taxable income.

x. Amendments to the Cyprus Income Tax Law

Notional interest of 9% on loans or other financial facilities that existed under prior law has been eliminated in most instances. However, if Cyprus resident individuals are the recipients, such loans are considered as benefits and taxed as personal income. For corporate shareholders, the arm's length principle is applicable and much lower interest rates are accepted. Regarding back-to-back loans, no notional interest rates will be applied.

xi. Penalties

An additional penalty is imposed for late payment of withholding tax in respect of royalties, film rights, and other Cyprus-sourced income derived by nonresidents. In the event a tax nonresident of Cyprus derives income from sources within Cyprus that is subject to withholding tax under the provisions of the Cyprus Income Tax Law, the payer of the income is obliged to withhold tax at source and submit the withheld amounts by the end of the month following the month in which payment was made.

In the event of non-payment within the deadline set by legislation or in a notification by the Commissioner of Income Tax, an additional penalty of 5% will be payable on the amount of tax due.

C. The Special Contribution for the Defense of the Republic Law

i. In General

The second revenue raising measure in Cyprus is the Special Defense Levy. It is a separate income tax imposed on certain dividends and interest.

- The rate of the Special Defense Levy on income from interest on investments has now increased from 15% to 30% but this only applies to residents of Cyprus.

- Nonresident shareholders of Cyprus resident companies are not subject to the Special Defense Levy.

- Dividends paid from one Cyprus resident company to another are exempt. Dividends received by a resident company from a nonresident are also exempt if either (i) the investment income of the nonresident company is less than 50% of its total income or (ii) the foreign tax burden is not substantially lower than the tax burden in Cyprus. This condition is met if either alternative is met. The term "substantially lower" is not defined within the Law and is therefore left to the discretion of the Income Tax authorities.

- Interest received in the ordinary course of business is exempt from the Special Defense Levy. However, investment interest is subject to the Special Defense Levy. In such latter case, the tax rate is now 30% applicable however only to residents of Cyprus.

ii. Penalties

Any person who refuses, fails or neglects to submit any notification or tax return or provide any information requested or does not perform any of his duties as those are explicitly prescribed by law with the deadline expressly prescribed by law is liable to a penalty of €100. This increases to €200 in case the Director of Inland Revenue serves a written notice.

D. Other Taxes

- Capital Gains Tax - Not applicable to profits earned from sale of securities, as seen above.

- Inheritance or Estate Taxes - There are no such taxes on shares held in a Cyprus company.

- Thin cap rules - There are no thin capitalization or transfer pricing rules in Cyprus Tax Law, with the only qualification that transactions should be based in accordance with the "arm's length principle."

E. Changes in Tax Registration Provisions

Obligations to register for a Tax Identification Code ("T.I.C.") exist under Cypriot tax law. A company is obliged to submit the relevant return and obtain a T.I.C. within 60 days from the date of its incorporation. Heavy fines are imposed for noncompliance.

F. Exchange of Information and Bank Confidentiality Rules

Bank Secrecy does not exist in Cyprus. The Director of Inland Revenue must obtain written consent from the Attorney General (AG) and must provide written notice to the person under investigation. Once those steps are taken, the Director retains the right to request any Bank to provide any information that the Bank has in its possession in relation to any existing or closed Bank account of a person under investigation by the tax authorities. The Director may request information for the period beginning seven years prior to the date of the request.

In order for the consent of the AG to be granted, the Director of Inland Revenue should apply himself to the AG and furnish both the AG and the Bank with 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 period of time for which the information is requested; the time period should be specific and reasoned; and

- A declaration that the Director has exhausted all means at its disposal to obtain the requested information, except where resorting to such means would have imposed an undue burden.

Additionally, the Director of Inland Revenue must inform the AG of the tax purpose and the reasons for which the information is requested and should inform the person under investigation of the written consent or of the refusal of such consent by the AG as soon as this information is made available.

Provision of information to Inland Revenue by civil servants is now permitted. The confidentiality bar on civil servants is removed. As a result, they are now under the obligation to reveal to the tax authorities upon request, any information they may have on the tax payer.

Field audits are permitted by the tax authorities. Clarifications have been introduced in the assessment and collection of taxes under Cypriot law so that, 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. In addition to books and records, the tax authorities may examine goods and documents found on the premises. Reasonable notice must be given to the interested party.

G. More Stringent Requirements from Various E.U. Jurisdictions

Several E.U. jurisdictions require more detailed explanations from clients using Cyprus private companies within their structure such as the length of time shares are held, copies of the transaction documents, confirmations from the Board of Directors that the Cyprus company is managed and controlled in Cyprus as well as the extent to which a presence in Cyprus is maintained. In the author's experience, no insurmountable requirements have arisen and there have been no cases where the foreign Tax Authorities have refused to allow the use of treaty and/or unilateral benefits such as exemptions from withholding tax at source.

H. Double Tax Treaties

Cyprus has developed an extensive network of Double Tax Treaties that offer excellent opportunities for international tax planning for a wide range of businesses. Set out below is the table of countries.

Armenia	France	Mauritius	Singapore
Austria	Germany	Montenegro	Slovak Republic
Belarus	Greece	Moldova	Slovenia
Belgium	Hungary	Norway	South Africa
Bulgaria	India	Poland	Sweden
Canada	Ireland	Romania	Syria
China	Italy	Russian Federation	Tajikistan
C.I.S. states *	Kuwait	San Marino	Thailand
Czech	Kyrgyszstan	Serbia/Montenegro	Ukraine
Republic	Lebanon	Seychelles	United Kingdom
Denmark	Malta		United States
Egypt			

* The Treaty concluded between Cyprus and the former U.S.S.R. is applicable to the following Republics of the Commonwealth of Independent States: Azerbaijan and Uzbekistan until each state wishes to abrogate the Treaty as to itself.

16. MALTA

A. Introduction

Malta is distinctive for its blend of civil law principles and U.K. statutory law, resulting in a body of pragmatic law with international application. The ideal method for conducting business in Malta is to establish a Maltese registered company. The Malta company may be used for any kind of activity without territorial limitation, regardless of whether the Malta company engages in holding activities, trading activities, or both.

The management of a Malta company is entrusted to a board of directors. Its members need not be residents of Malta. Maltese corporate law allows corporations to serve as members of a board of directors. The Malta Financial Services Authority (the Maltese financial services regulator) has issued corporate governance guidelines as practical guidance to promote a desired standard of performance. The directors of a Malta company are personally liable for the tax due by the company. Liability for payment of the Value Added Tax Act is extended to all the officers of a company, including the company secretary and persons occupying managerial positions within the company. Comparable personal liability is imposed upon the liquidator of a company that is in the process of liquidation.

The preparation of financial statements in Malta is regulated by the Companies Act, the Maltese Income Tax Acts and the Accountancy Profession Act. Financial statements are prepared in accordance with International Financial Reporting Standards including those already adopted by the European Union ("I.F.R.S."). However, smaller entities not meeting a designated threshold of assets and income may adhere to Maltese Generally Accepted Accounting Principles, as permitted under the Accountancy Profession Act.

B. Taxation of Company Profits

Malta companies are taxed at the rate of 35%. Certain types of income such as bank interest and the proceeds of sale of immovable property situated in Malta are charged at a final withholding tax of 15% and 12% respectively. The income derived by a company from qualifying participation holdings may be excluded from the tax computation, provided that certain anti-abuse provisions are satisfied. The tax on trading income is levied on the chargeable income earned in the previous year of assessment, after accounting for deductible expenses wholly and solely incurred in the production of the income. Malta applies the full imputation system of taxation, as a result of which the tax paid by the company is allowed as a credit when dividends are received by the shareholders.

Companies that are in compliance with their tax obligations may be furnished with a Fiscal Residence Certificate issued by the Commissioner of Inland Revenue upon the Company's request proving the Company's fiscal good standing in accordance with Maltese fiscal legislation.

C. Tax Accounting

Profits generated by a company are allocated to the Final Taxed Account, Foreign Income Account, Immovable Property Account, the Maltese Taxed Account and the Untaxed Account, depending on the revenue streams flowing into the company. The allocation of profits to these accounts is of relevance when considering the distributions made by the company, and in particular, when an application for a tax refund is filed by the shareholder receiving the dividend as permitted under the Maltese Income Tax Acts. Distributions are to be made in the following order of priority: (i) profits allocated to the final tax account, (ii) profits allocated to the immovable property account, (iii) followed by distributions from the foreign income account and (iv) the Maltese taxed account. The allocation of profits is classified as follows:

- Final Taxed Account. The profits allocated to this account comprises income which, in accordance with the provisions of the Income Tax Act are subject to a final withholding tax or in respect of which no further tax is payable. The full imputation system does not apply to the Final Taxed Account. Distributions from the Final Taxed Account are not chargeable to further tax.

- Immovable Property Account. The profits allocated to the immovable property account comprise income which is derived from immovable property situated in Malta. Such profits include, inter alia, gains on the sale of property, rents, interest on loans to finance the acquisition of property in Malta, income from hotel

accommodation income, insurance premiums related to property in Malta and indeed any other income which is connected with immovable property. It also includes a notional allocation in those instances where the property is owned by the company and is used for the purpose of its business activities.

- Foreign Income Account. The profits allocated to this account comprise income from sources outside Malta and include, inter alia, royalties, dividends, capital gains, interest, rents, income derived from a participating holding and profits attributable to a permanent establishment outside Malta.

- Maltese Taxed Account. The profits allocated to the Maltese taxed account relate to those which have suffered tax generally at the rate of 35%. It does, however, include profits on which a lower rate of tax has been applied.

- Untaxed Account. The allocation to this account represents the arithmetical difference between the total profits earned by the company and those which are allocated to the various tax accounts. Distributions out of the Untaxed Account are subject to 15% withholding tax whenever the recipient is a Malta resident individual. On the other hand, non-resident individuals in relation to Malta and Malta resident companies fall outside the definition of "recipient" and the withholding tax is not applicable.

D. The Maltese Refundable Tax System

The Maltese refundable tax system, as approved by the European Union, offers a significant advantage because, when a company distributes its profits, the shareholders receiving the dividend become entitled to a refund of the tax paid by the company. The amount of the refund depends on the nature of the income. The various types of refunds, and the circumstances under which these apply, are now explained.

- Two-Thirds Refund. A two-thirds refund of the tax paid by the company may be availed of when dividends are paid out to the shareholders from profits allocated to the foreign income account where the distributing company has availed itself of any form of double taxation relief (treaty relief, unilateral relief or relief under the flat rate foreign tax credit method).

- The 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, however, does not consist of passive income or royalties.

- The Five-Sevenths Refund. The five-sevenths refund applies to distributions of profits derived from passive interest, from royalties and from dividends received from participating holdings that does not meet the anti-abuse provisions

- Full Refund. The shareholders may apply for a full refund of the Malta tax paid by the company in those instances where a dividend has been paid to them from profits derived by the company in respect of its income which is received from a participating holding. When such income qualifies as a participation exemption, the company receiving the income may exclude such income from the income tax computation. In this instance, the income will be allocated to the final tax account and no further tax will arise on the distribution of the income allocated to this account when paid to non-residents of Malta.

E. Transfer of Shares in a Malta Company

Malta imposes a stamp duty on transfers of shares in a Malta company. However, the transfer of shares in a company in which more than half the ordinary share capital, voting rights and rights to profits are held by persons who are not resident in Malta (or by a trustee of a trust in which all beneficiaries are nonresident in relation to Malta) and not owned or controlled directly or indirectly by persons resident in Malta, are exempt from stamp duty. Likewise, the transfer of shares in a company by non-residents are the subject of an exemption from taxation pursuant to the provisions of the Income Tax Acts, and therefore no capital gains tax is due on such a transfer. The exemptions apply in those instances where the company is not treated as a "property company," that is a company which owns immovable property in Malta.

F. Double Taxation Relief

Relief from double taxation in terms of the Income Tax Acts may take one of three forms: (i) treaty relief, (ii) unilateral relief, or (iii) flat rate foreign tax credit.

i. Treaty Relief

Treaty Relief may be availed of if the following criteria are satisfied:

- Under the relevant double tax treaty, a provision is made for the foreign tax paid in the other state is to be allowed as a credit against tax payable in respect of that income in Malta;
- The foreign tax is of a similar character to the tax imposed in Malta; and
- The person making the claim is a resident in Malta during the year immediately preceding the year of assessment and tax is payable on such income.

No credit is allowed if a person elects that the credit should not be allowed against income tax chargeable in respect of his income for that year. A claim must be made not later than two years after the end of the year of assessment to which the claim refers, unless a claim is considered excessive or insufficient by reason of any adjustment of the amount of tax payable in Malta or in the other state. In such case the two-year time limit for making the claim starts running from the date of the adjustment.

Malta has concluded Double Taxation Treaties with 62 states, namely:

Australia
Austria
Bahrain
Barbados
Belgium
Bulgaria
Canada
China
Croatia
Cyprus
Czech Republic
Denmark
Egypt
Estonia
France
Georgia
Germany
Greece
Guernsey
Hungary
Hong Kong
Iceland
India
Ireland
France
Georgia
Germany
Greece
Guernsey
Hungary
Iceland
India
Ireland
Isle of Man
Italy
Jersey
Jordan
Korea (South)
Kuwait
Latvia
Lebanon
Libya
Lithuania
Luxembourg
Malaysia
Montenegro
Morocco
Netherlands
Norway
Pakistan
Poland
Portugal
Qatar
Romania
San Marino
Saudi Arabia
Serbia
Slovakia
Slovenia
South Africa
Spain
Sweden
Switzerland
Syria
Tunisia
United Arab Emirates
United Kingdom
United States of America
Uruguay

Protocols to the current treaties in force between Malta and Belgium, Luxembourg, Singapore and South Africa have been signed and are still pending ratification and entry into force.

A new Double Taxation Treaty has been signed between Malta and Norway in March 2012 and upon entry into force, this Treaty will replace the current treaty which has been in force since 1979. Likewise, a new Double Taxation Treaty has been signed between Malta and India in April 2013 and upon entry into force will replace the current treaty in force since 1995.

A further four treaties have been signed but are not yet in force, namely Israel, Mexico, the Russian Federation, and Turkey.

Four treaties are currently in various stages of negotiation, including Bosnia and Herzegovina, Oman, Thailand, and Ukraine.

The double taxation agreement between the U.S. and Malta was signed on November 2, 2010, and entered into force as of January 1, 2011. The double taxation agreement replaces an earlier agreement which was terminated in 1997. The agreement eliminates barriers to cross border trade and investment while preventing tax evasion between Malta and the United States. It is designed to ensure that U.S. and Maltese citizens are taxed only once on their profits and income, and to limit withholding payments on dividends, royalties and other unearned income.

Towards the objective on enhancing Malta's international tax obligations as well as complementing its double taxation treaty network, Malta has in 2012 signed Exchange of Information Agreements with three states: the Bahamas, Bermuda and Gibraltar. None of these agreements are in force as yet.

ii. Unilateral Relief

In order to claim unilateral relief, the following conditions must be met:

- Treaty relief must not be available to the person making the claim;
- The income arises outside Malta and is subject to tax in the state of source;
- The foreign tax is of a similar character to the tax imposed in Malta;
- The person entitled to the income is resident in Malta, or is a company registered in Malta for the year immediately preceding the year of assessment, and tax is payable on such income; and
- The person making the claim proves to the satisfaction of the Commissioner of Inland Revenue that the foreign income has borne foreign tax and proves the amount of such tax.

No credit is allowed if a person elects that the credit should not be allowed against income tax chargeable in respect of his income for that year. A claim must be made not later than two years after the end of the year of assessment to which the claim refers, unless a claim is considered excessive or insufficient by reason of any adjustment of the amount of tax payable in Malta or in the other state. In such case the two-year time limit for making the claim starts running from the date of the adjustment.

iii. Flat Rate Foreign Tax Credit

The Flat Rate Foreign Tax Credit is available if the following conditions are met:

- Treaty relief and unilateral relief must not be available to the person making the claim;
- Income or gains must be received by a company registered in Malta, which includes a Maltese branch of a non-resident company;
- The Company must specifically be empowered to receive such income or gains;
- Such income or gains must fall to be allocated to the foreign income account; and
- Documentary evidence must be available indicating to the satisfaction of the Commissioner of Inland Revenue that the income or gains fall to be allocated to the foreign income account.

No credit is allowed if a person elects that the credit should not be allowed against income tax chargeable in respect of his income for that year. A claim must be made not later than two years

after the end of the year of assessment to which the claim refers, unless a claim is considered excessive or insufficient by reason of any adjustment of the amount of tax payable in Malta or in the other state. In such case the two-year time limit for making the claim starts running from the date of the adjustment.

G. Conclusion Applicable to Malta

The legal framework in Malta offers a number of key advantages for those seeking to conduct international business in a sound and reputable jurisdiction. The taxation system in Malta contains no thin capitalization rules. Transfer pricing rules are very flexible and there are no withholding taxes on remittances to nonresidents with respect to dividends, interest and royalties. The legislation in Malta permits companies to migrate to and from Malta. Branches of overseas companies enjoy the same tax treatment applicable to companies incorporated in Malta. Incorporation and winding up procedures are relatively easy. The whole Malta package is indeed an attractive one in today's business environment.

17. CONCLUSION

For those companies looking to establish a holding company in Europe, a wide range of options is available. Choices begin with companies formed in jurisdictions that are well known for favorable tax rules and extend to companies formed in what are commonly viewed to be more highly taxed jurisdictions. Most European jurisdictions provide favorable tax treatment for dividends and gains in a parent-subsidiary context and mechanisms for dividend payments to be exempted from withholding tax. However, challenges to an applicable treaty or structure should be anticipated in the country where a dividend-paying subsidiary is located. As a result, the specific factors controlling the choice of jurisdiction likely entail a blending of favorable tax law with the business history of the group. The holding company likely must be viewed to have substance in order for internal dividend withholding taxes in Europe to be eliminated. Like beauty, substance is in the eye of the beholder.

--End--