ruchelman

corporate
international
taxation

INSIGHTS

OUTBOUND ACQUISITIONS: HOLDING COMPANIES OF EUROPE – A GUIDE FOR TAX PLANNING, OR A ROAD MAP FOR DIFFICULTY?

Insights Special Editions

TABLE OF CONTENTS

EDITORS' NOTE

This special edition of *Insights* examines the use of holding companies in a post-B.E.P.S. Europe that penalizes abusive tax planning as understood by the European Commission, the O.E.C.D., and national tax authorities. It is a world in which

- tax plans bifurcating a transaction into several separate steps or a bifurcating a structure so that several affiliates carry on various segments of a plan may be viewed to be illegal State Aid if confirmed by a tax ruling;
- tax plans are viewed to be abusive when they result in double non-taxation; and
- over 1,100 treaties affecting 70 jurisdictions were modified by the execution of a single multinational instrument ("M.L.T.") on June 7, 2017, and up to an additional 1,250 treaties may be modified by the M.LT.

In this edition of *Insights* we will address the benefits that are obtainable in 15 European jurisdictions under the planning norms in effect in 2017. Contemporary tax plans must take into account the new reality spawned from the B.E.P.S. Project and several initiatives of the European Commission that are intended to eliminate certain cross-border tax planning arrangements.

To provide a comprehensive assessment, this edition features authors who are leading tax lawyers in their respective countries and recognized experts on B.E.P.S. and European Commission initiatives.

We hope you enjoy this issue.

- The Editors

INTRODUCTION

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

IN GENERAL

When a U.S. company acquires foreign targets, the use of a holding company structure abroad may provide certain global tax benefits. The emphasis is on "global" because standard U.S. benefits such as deferral of income while funds remain offshore may not be available without further planning once a holding company realizes dividends and capital gains. In addition, the operative term is "may provide" because of steps that have been taken by the Organization for Economic Cooperation and Development ("O.E.C.D."), the European Commission, and the European Parliament to impede tax planning opportunities that have been available to multinational groups for many years.

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 created under the laws of a different 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.[1] If paid to a holding company that 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]

All of the authors acknowledge the assistance of Francesca York, a paralegal at Ruchelman P.L.L.C., for converting 17 separate submissions prepared by persons having a multitude of birth languages into a cohesive and accurate monograph.

---

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

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

BENEFITS OF HOLDING COMPANIES

Nonetheless, the use of a holding company can provide valuable tax-saving opportunities when profits of the target company are distributed. Historically, the use of a holding company could reduce foreign withholding taxes claimed as foreign tax credits by the U.S. parent. This could be achieved through an income tax treaty, or in the case of operations in the E.U., through the Parent-Subsidiary Directive (the "P.S.D."). This can result in substantial savings if the operating and tax costs of maintaining the holding company are significantly less than the withholding taxes being saved.

However, as will be described below, the E.U. has taken steps to modify the P.S.D. so that it does not apply when the parent is in turn owned by a company based outside the E.U. and the structure is viewed to be abusive. In addition, all of the European countries discussed in this paper signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument") on June 7, 2017. Once the Multilateral Instrument comes into force in a particular European jurisdiction, it will take effect on the first day of the following calendar year or taxable period. Under Article 7 ("Prevention of Treaty Abuse") of the M.L.I. benefits enjoyed by a European holding company in connection with dividends paid by a European operating company may be limited when

> it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.[3]

It remains to be seen how this provision will play out for holding companies that are used to channel dividends to U.S. parent companies. Presumably, where the holding company conducts active headquarters operations through its own staff of employees and executives, treaty abuse may be a conclusion that is difficult to reach.

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.[4] This rule, known as "the foreign tax credit limitation," is intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S. taxable income. The U.S., as with most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income. It also prevents so-called "cross crediting," under which high taxes on operating income may be used to offset U.S. tax on lightly-taxed investment income. For many years, the foreign tax credit 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

---

3 Paragraph 1 of Article 7 of the Multilateral Instrument.

4 Code §904(a).

foreign tax credit when looked at on an overall basis. The problem has since eased because the number of foreign tax credit baskets has been reduced from eight to two: passive and general.

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.[5] 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.

"The allocation and apportionment procedures set forth in the regulations are exhaustive and tend to maximize the apportionment of expenses to foreign-source income."

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.

ALLOCATION AND APPORTIONMENT REGULATIONS AND SELF-HELP OPTIONS

U.S. income tax regulations require expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.[6] 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.[7] Direct tracing of interest expense to income derived from a particular asset is permitted in only limited circumstances[8] involving qualified nonrecourse indebtedness,[9] certain integrated financial transactions,[10] and certain related C.F.C. indebtedness.[11] 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.[12] 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

---

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

6 See Treas. Reg. §§1.861-8 through 17.

7 Treas. Reg. §1.861-9T(f)(1) and (g).

8 Treas. Reg. §1.861-10T(a).

9 Treas. Reg. §1.861-10T(b).

10 Treas. Reg. §1.861-10T(c).

11 Treas. Reg. §1.861-10T(e).

12 Code §904(f).

and reduces the foreign-source taxable income of the subsequent year when computing the foreign tax credit limitation.

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

ANTI-INVERSION RULES

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

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

remove untaxed foreign earnings and profits of C.F.C.'s through related-party stock sales subject to Code §304 (which converts a stock sale of controlled stock into a dividend payment).

In 2016, the Treasury Department adopted updates to the U.S. Model Income Tax Convention (the "2016 U.S. Model"), which serves as the basic document that the U.S. submits when negotiating an income tax treaty. The draft provisions propose, *inter alia*, to reduce the tax benefits that may be enjoyed by an expatriated group by imposing full withholding taxes on key payments such as dividends,[13] interest,[14] and royalties[15] made to connected persons that are residents of a treaty country by "expatriated entities" as defined under the Internal Revenue Code. This lasts for ten years and goes to the heart of the bargain between the U.S. and its treaty partners, because the full withholding tax reduces the tax in the country of the recipient.

In Notice 2015-79, the I.R.S. outlined forthcoming guidance on corporate inversions in response to perceived abuse. The abusive plans and the I.R.S. responses include the following:

- **Manipulating Substantial Activity Rules:** The I.R.S. is aware of transactions in which a taxpayer asserts that the expanded affiliated group ("E.A.G.") has substantial business activities in the relevant foreign country, but the foreign acquiring corporation is not subject to income taxation in the relevant foreign country as a resident. According to the I.R.S., this is abusive.

- **Third Country Transactions:** The I.R.S. is aware that certain acquisitions in which a domestic entity combines with an existing foreign corporation are structured by establishing a new foreign parent corporation with a tax residence that is different from that of the existing foreign corporation. In these transactions, the stock or assets of the existing foreign corporation are acquired by the new third-country parent and the U.S. shareholder group owns less than 80% of the parent in the third country. The I.R.S. is concerned that a decision to locate the tax residence of a new foreign parent corporation outside of both the United States and the jurisdiction in which the existing foreign corporation is tax resident generally is driven by abusive tax planning.

- **Disregard of Stock Transferred in Exchange for Nonqualified Property:** Stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition is excluded from the denominator of the ownership fraction. Disqualified stock includes stock of the foreign acquiring corporation that is transferred in exchange for "nonqualified property." Nonqualified property includes (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations, and (iv) any other property acquired with a principal purpose of avoiding the anti-inversion rules. The I.R.S. is concerned that some taxpayers are narrowly interpreting the definition of avoidance property, contending that it is limited to stock that is used to transfer indirectly specified nonqualified property to the foreign acquiring corporation.

- **Post-Acquisition Transactions:** The I.R.S. is concerned that certain indirect transfers of stock or other property by an expatriated entity, rather than

---

13 Paragraph 5 of Article 10 (Dividends) of the 2016 U.S. Model.

14 *Id.*, ¶2(d) of Article 11 (Interest).

15 *Id.*, ¶2 of Article 12 (Royalties).

direct transfers by the expatriated entity itself, have the effect of removing foreign operations from the U.S.'s taxing jurisdiction. This is because under current law, the income from these indirect transfers is not inversion gain. Consequently, attributes can be used to reduce the tax.

- **Code §1248 Toll Charges:** Current §367(b) regulations require a shareholder that exchanges stock in a transaction which results in a loss of C.F.C. status and future exposure under Code §1248 to include the Code §1248 amount in its income as a deemed dividend. The I.R.S. is concerned that the toll charge is not a sufficient deterrent.

On April 4, 2016, the Treasury Department issued a third round of new rules under Code §7874 aimed at halting the wave of inversions that have allowed U.S.-owned multinational groups to restructure their global organization in order to lower U.S. taxes. The Treasury sought to close down a planning strategy used by some foreign companies in which multiple acquisitions of unrelated U.S. target corporations are made over time. This strategy allowed the foreign companies to avoid the application of §7874, since each acquisition was analyzed on its own.[16] The prevention of this strategy is accomplished under a multiple domestic entity acquisition rule set forth in Treas. Reg. §1.7874-8T.[17]

The Treasury was concerned that certain taxpayers were targeting foreign corporations with a value that was attributable to substantial passive assets rather than business assets. Treas. Reg. §1.7874-7T incorporates a rule that identifies certain foreign corporation stock which has substantial value and is attributable to passive assets. When triggered, this rule will skew the ownership fraction in the direction of the former shareholders of the domestic acquired corporation so that Code §7874 may apply.

A so-called "anti-skinnying" rule of the First Notice would disregard any non-ordinary course distribution ("N.O.C.D.") made by the domestic entity during the 36-month period ending on the acquisition date.[18]

Other rules apply Code §§956, 367, and 304 in a manner that imposes tax on typical transactions that occur after an inversion.

FAVORABLE TAX BENEFITS THROUGH PROPER USE OF HOLDING COMPANIES

In this universe, the combination of foreign taxes imposed on the income earned by a subsidiary and the withholding taxes imposed on the distribution of dividends may generate foreign tax credits in excess of the foreign tax credit limitation. Dividend withholding taxes represent true costs for the offshore parent company, because of its location in a tax-favored jurisdiction. Intelligent use of a holding company structure may eliminate or reduce the withholding tax imposed on the distribution of foreign profits. To illustrate, most but not all European countries impose a withholding

---

16 T.D. 9761, Explanation of Provisions, I(B)(3). (April 8, 2016); Treas. Reg. §1.7874-12T(a)(17).

17 Treas. Reg. §1.7874-8T(b).

18 Treas. Reg. §1.7874-7T(h). Because it is a temporary regulation, this regulation expires in three years.

tax on dividends paid to foreign persons that are not resident in an E.U. Member State. 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 an E.U. Member State to a parent company that is resident in a different Member State, if 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, provided that establishment of the holding company is not viewed to be abusive in light of all facts and circumstances. A jurisdiction is favorable if the withholding tax paid on dividends received by the holding company and the withholding tax imposed on dividends paid by the holding company are low or nil and relatively little income tax is paid on the receipt of intercompany dividends or on gains from the disposition of shares of a subsidiary.

For multinational groups held by fiscally transparent entities in the U.S., such as L.L.C.'s, the maximum rate of U.S. tax for non-corporate members, such as individuals and nongrantor trusts, is 20%. In addition, dividends or inclusions of income under Subpart F or the passive foreign investment company ("P.F.I.C.") rules applicable to Qualified Electing Funds[19] are subject to the U.S. "net investment income tax."[20] 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[21] over a threshold amount varying from $125,000 to $200,000, depending on the individual's filing status. Net investment income consists of certain passive income reduced by allocable deductions. Passive income includes gross income from dividends. It also includes passive income in the form of interest, annuities, royalties, rents, and other gross income if the gross income is derived either from a trade or business in which the U.S. individual does not materially participate or from a trade or business of trading in financial instruments or commodities. Net investment income also includes net gain attributable to the disposition of property held in one of those two types of trade or business activities. Regulations address the application of the 3.8% tax in the case of U.S. individual shareholders in C.F.C.'s or P.F.I.C.'s by providing that the tax may be imposed either at the time of the income inclusion or a subsequent time when cash is received.[22]

"For multinational groups held by fiscally transparent entities in the U.S., such as L.L.C.'s, the maximum rate of U.S. tax for non-corporate members, such as individuals and nongrantor trusts, is 20%."

In 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, the United Kingdom, Belgium, Spain, Cyprus, and the Netherlands. In Ireland, the tax rate is extremely low for

---

[19] Code §1293, which provides for the current taxation regime applicable to shareholders in connection with income derived by Qualified Electing Funds.

[20] Code §1411.

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

[22] Treas. Reg. §1.1411-10.

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 corporation 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.

EUROPEAN ATTACKS ON CROSS-BORDER HOLDING COMPANIES AND TAX PLANNING

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

Substance is also a key concern in the Final B.E.P.S. Package for Reform of the International Tax System to Tackle Tax Avoidance published by the O.E.C.D.[23] The reports were commissioned by the G-20 and reflect findings that a disparity exists between (i) the location of actual business activities and investment, and (ii) the jurisdiction where the resulting profits are reported for tax purposes.

The reports set out how current cross-border taxation rules may create B.E.P.S. opportunities, thereby resulting in a reduction of the share of profits associated with substantive operations. They also emphasize how changes in global business practices are ahead of current international tax standards, with a special focus on intangibles and the digital economy. The reports identify (i) a need for increased transparency on the effective tax rates of multinational enterprises, and (ii) the existence of key pressure areas as far as B.E.P.S. is concerned. They include

- international mismatches in entity and instrument characterization,
- application of treaty concepts to profits derived from the delivery of digital

[23] The full B.E.P.S. 2015 Final Reports appear online here.

goods and services,

- the tax treatment of related party debt-financing,
- captive insurance and other intra-group financial transactions,
- certain aspects of generally recognized transfer pricing rules,
- the effectiveness of anti-avoidance measures, and
- the availability of harmful preferential regimes.

The reports adopt a set of comprehensive, global, internationally-coordinated action plans to effectively address the identified problem areas. The O.E.C.D. governments are particularly committed to the development of proposals to implement this action plan. Many U.S.-based multinational groups fear that the proposals will overturn arm's length principles that have been recognized internationally for many years.

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

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

Also at issue are attacks on cross-border transactions that arise within the E.U. In particular, challenges have been raised based on concepts of State Aid, transparency, and the Common Reporting Standard. Until recently, tax planning was not viewed to be an item of unfair State Aid violating basic rules of the E.U. That has changed. In its place is a mechanism calling for information reporting designed to promote pan-European information exchange, both as to bank balances and "sweetheart" tax rulings.

Following the O.E.C.D. B.E.P.S. reports, the European Commission introduced an Anti-Tax Avoidance Directive ("A.T.A.D. 1"). It was adopted on June 20, 2016, and contains anti-tax avoidance rules in five specific fields:

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

- Hybrid mismatches

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

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

- Hybrid financial instrument mismatches
- Hybrid entity mismatches
- Reverse hybrid mismatches
- Hybrid transfers
- Hybrid permanent establishment mismatches
- Dual resident mismatches

Member States must implement the A.T.A.D. 2 by December 31, 2019, in general, and by December 31, 2021, regarding reverse hybrids.

PATH FORWARD

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

B.E.P.S. AND HOLDING COMPANIES

Author
Eric Fort
Arendt & Medernach
Luxembourg

BACKGROUND

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

This project marks a sea change for some and the dawn of an improved system of international tax justice for others, especially academics and tax authorities. The B.E.P.S. Project originates from the meeting of government finance ministers and central bank governors from 20 major economies (the "G-20") in Moscow in 2013. The accompanying *communiqué*[1] pointed out that globalization had damaged many states' core sovereignty, *i.e.*, their capacity to legitimately levy a compulsory tax on income produced by their residents. As observed later in 2013 by the O.E.C.D., the interaction of independent sets of rules enforced by sovereign countries creates friction, including potential double taxation for corporations operating in several countries, and it can also create gaps in cases where corporate income is not taxed at all, either by the country of source or by the country of residence, or where it is taxed only at nominal rates.[2]

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

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

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

B.E.P.S. ACTION PLAN

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

1 Communiqué of February 16, 2013.

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

3 *Id.*

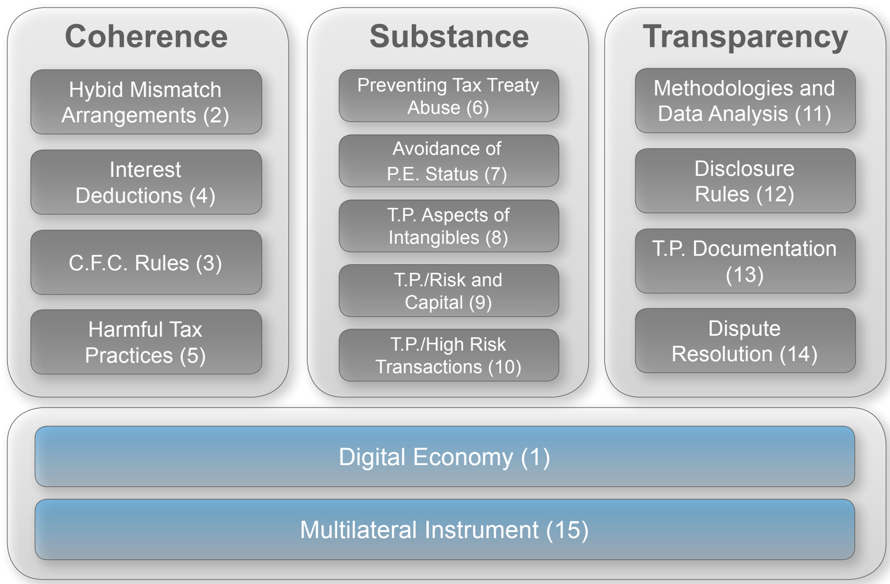
4 O.E.C.D. (2013), *Addressing Base Erosion and Profit Shifting*, O.E.C.D. Publishing.

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

The actions are organized around three main pillars:

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

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



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

As an initial response, the O.E.C.D. Committee on Fiscal Affairs adopted a preliminary set of seven reports and recommendations, which it published on September 16, 2014. This work reflected the view that different stakeholders must participate in the initiative. Developing countries and other nonmember economies of the O.E.C.D. and G-20 were consulted at numerous meetings and forums. In addition, business representatives, trade unions, banks, academics, and civil society organizations were given the opportunity to express themselves by commenting on discussion papers published by the O.E.C.D.

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

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

- **Action Item 1:** Addressing the Tax Challenges of the Digital Economy

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

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

Compliance with the minimum standards will be subject to peer review by O.E.C.D. members and the G-20 in accordance with a more in-depth framework, which is yet to be conceived.

Despite constituting soft law, the Final Recommendations are in the process of implementation by the G-20, European countries, and others.

REFLECTING A SEA CHANGE IN ACCEPTABLE TAX PLANNING

The B.E.P.S. Project demonstrates the passage from a system highlighted by individual competition among states for the greater good of one state to a system of international cooperation that reflects fiscal harmony, rather than abusive practices by certain operators. Cynics might say that the change is one in which smaller

[5] O.E.C.D. (2015), *Explanatory Statement*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D.

economies that thrived on arrangements to reduce tax in other countries will be required to reshape their economies to focus on more productive endeavors.

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

In calling for an internationally coordinated response, the B.E.P.S. Project requires support from each state at the domestic level. Each state retains its fiscal sovereignty and is free to apply the measures proposed by the O.E.C.D. on different terms, as long as it does not go against its international legal commitments. Thus, an adjustment period may be required in order to renegotiate tax treaties or to amend domestic law. At the same time, the O.E.C.D. created a mandate through Action Item 15 that called for an international conference to develop a multilateral instrument to amend the network of existing bilateral tax treaties in order to implement the B.E.P.S. Project's treaty measures all at once (the "M.L.I."). On November 24-25, 2016, negotiations among over 100 jurisdictions regarding the M.L.I. were concluded and a signing ceremony was held on June 7, 2017 in Paris. The M.L.I. is expected to be transposed into more than 2,000 tax treaties worldwide.

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

EFFECTS ON HOLDING COMPANY STRUCTURES

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

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

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

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

Focus

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

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

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

jurisdiction and as to their economic substance in another

- Hybrid entities, *e.g.*, entities that are treated as taxable in one jurisdiction and transparent in another

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

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

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

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

Illustrative Fact Patterns

For the purpose of this section and due to the broad scope of Action Item 2, only a few examples of hybrid mismatch arrangements will be presented. Typical hybrid mismatches that lead to a D./N.I. outcome are illustrated by structures involving hybrid financial instruments. The instrument is treated as debt in the issuer's country of residence and as equity in the holder's country. The issuer of the instrument treats its payment as deductible interest and the payee/holder treats the payment as a tax-exempt dividend.

Another example of hybrid mismatch can be found in arrangements with payments to reverse hybrid entities. Such entities are treated as tax transparent in one jurisdiction and as opaque in another. By way of illustration, a company that is resident in Country A owns all the issued and outstanding shares in a subsidiary resident in Country B. The subsidiary was formed under the laws of Country B. The subsidiary is tax transparent under Country B's laws but is regarded as a separate taxable entity under the laws of Country A. Company C, residing in Country C, borrows money from the subsidiary and makes an interest payment under the loan. The payment is deductible under Country C's tax law but is not included in income under the laws of either Country A or B. Each of those countries treats the income as being derived by a resident of the other jurisdiction.[6]

A third example of a hybrid mismatch transaction involves the payment made by a hybrid entity. In this scenario, the payer is usually tax transparent under the law of the jurisdiction of its parent or investor, but not in its own jurisdiction. By way of illustration, Company A, a resident in Country A, owns all the issued and outstanding shares in Company B, a resident in Country B. Under the laws of Country A, Company B is viewed to be a branch of Company A. The tax transparent subsidiary borrows from Company A and pays interest on the loan. The loan is ignored under

---

6 O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

the laws of Company A. Because Company B is the parent of a consolidated group in Country B, the interest paid to Company A gives rise to a deduction that reduces the income of the Company B group. Nonetheless, there is neither income nor tax in Country A because the loan and the interest are treated as an internal transaction that is disregarded for the purposes of Country A law.

Recommended Action

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

With respect to the domestic rules, the report recommends a denial of deductions in the country of the payer of the interest as the primary rule, and if the primary rule is not adopted in the relevant country, the imposition of tax in the country of the recipient as a secondary rule. In practice, when two jurisdictions are involved in a hybrid mismatch arrangement, the primary rule should determine which of the two jurisdictions ensures that tax is collected. In the event the jurisdiction of the payer has not introduced relevant hybrid mismatch legislation, the jurisdiction of the recipient should be entitled to rely on the secondary rule to neutralize the mismatch. Additionally, the report recommends improving controlled foreign corporation ("C.F.C.") rules and the limitation of the tax transparency of reverse hybrids. In addition, the report advocates the implementation of rules that will adjust the tax outcome in one jurisdiction and align them with tax consequences in another.

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

The implementation of anti-hybrid mismatch measures which have already been undertaken in Europe through amendments to the E.U. Parent-Subsidiary Directive ("P.S.D.")[7] may lead to disadvantageous situations for some taxpayers.

B.E.P.S. ACTION 3: DRAFTING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES[8]

Focus

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

---

7 Council Directive 2014/86/E.U. amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 2014 O.J. L 219/40.

8 O.E.C.D. (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

in the taxable base of the controlling entity in relation to the C.F.C.

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

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

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

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

<u>Recommended Actions</u>

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

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

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

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

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

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

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

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

Double taxation can appear as a result of C.F.C. rules when C.F.C. income is subject to corporation income tax in two or more jurisdictions, or if the same C.F.C. income is targeted by more than one jurisdiction. In these two cases, the O.E.C.D. recommends that a tax credit should be allowed in the parent jurisdiction. For the avoidance of doubt, this tax credit amount should correspond to all taxes due from the C.F.C. on income that has not qualified for other tax relief, but should not exceed the tax amount due on the same income in the parent jurisdiction.

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

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

Focus

Action Item 4 focuses on the need to address B.E.P.S. using deductible payments, such as interest, that can give rise to double nontaxation in inbound and outbound investment scenarios.[9]

The fact patterns deemed to be abusive are those that allow the use of

- intra-group loans to generate deductible expenses in a high-tax jurisdiction and taxable interest income in low-tax jurisdictions,
- interest deductions on loans that finance assets that produce exempt income or income recognized on a deferred basis,
- hybrid mismatches between jurisdictions generating interest deductions but

[9] O.E.C.D. (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

no taxation of income, and

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

Recommended Action

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

> ***"Under Action Item 4, the O.E.C.D. remains flexible on the implementation of the recommended approach and additionally offers the opportunity for each country to implement more specific rules."***

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

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

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

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

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

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

Focus

Another B.E.P.S. Action substantially affecting holding companies is the portion of Action Item 5 that is intended to "counter harmful tax practices more effectively, taking into account transparency and substance." Previous O.E.C.D. publications, such as the O.E.C.D.'s 1998 report *Harmful Tax Competition: An Emerging Global Issue*,[10] show that the topic has been discussed for many years among the different stakeholders. Action Item 5 proposes to reorganize the existing material gathered by the Forum on Harmful Tax Practices (the "Forum") with regard to aggressive benefits granted to cross-border transactions by various countries in their respective domestic tax laws.

Illustrative Fact Patterns

Described below is a typical argument and organization used by an M.N.E. when investing in intellectual property through a jurisdiction offering an attractive I.P. regime.

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

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

Recommended Action

In October 2015, a final report on Action Item 5 was published.[11] In broad terms, Action Item 5 is aimed at tackling any corporate arrangements benefiting from disproportionate tax advantages in a given jurisdiction. It requires that corporate substance and activity should be in line with taxation and that tax transparency should be enhanced through the exchange of rulings related to low tax schemes.

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

As mentioned in the report, the nexus approach is the approach selected to impose a substantial activity requirement for preferential I.P. regimes. The nexus approach enables a taxpayer to benefit from an I.P. regime if it has itself performed the research and development that gives rise to the I.P. income. The nexus approach recommends that M.N.E.'s adjust their operational substance activity so that the tax

---

10 O.E.C.D. (1998), *Harmful Tax Competition: An Emerging Global Issue*, O.E.C.D. Publishing, Paris.

11 O.E.C.D. (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

benefit from the regime is closely tied to the economic reality of operations. In other words, income derived from eligible I.P. rights benefit from a favorable tax treatment only in proportion to the research and development expenditures (compared to global expenditures) incurred by the taxpayer in relation to the I.P. rights.

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

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

The second milestone of Action Item 5 is the improvement of transparency, including the mandatory exchange of rulings regarding low-tax schemes. With regard to transparency, the work of the Forum follows a three-step approach. The first step aims to develop a framework for compulsory spontaneous information exchange on rulings, while the second step focuses on the application of this framework, including a review of ruling regimes in force in O.E.C.D. and associated countries. As a third part, the Forum sets guidelines for countries still using such ruling procedures.

The scope of the automatic exchange of ruling procedure covers six categories of rulings, *viz.*, (i) rulings relating to preferential regimes, (ii) unilateral advance pricing rulings or other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits, (iv) permanent establishment rulings, (v) related party conduit rulings, and (vi) any other type of ruling which could give rise to B.E.P.S. concerns.[12]

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

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

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

12 *Id.*, p. 46.

information and lower administration costs.

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

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

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

On February 1, 2017, the O.E.C.D. released the *Terms of Reference and Methodology for Peer Reviews*[13] addressing the exchange of information on tax rulings. The peer review and the monitoring process will be conducted by the Forum to ensure the effective implementation of the agreed-upon standards.

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

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

Focus

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

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

---

13 O.E.C.D. (2017), *B.E.P.S. Action 5 on Harmful Tax Practices – Terms of Reference and Methodology for the Conduct of the Peer Reviews of the Action 5 Transparency Framework*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D., Paris.

Project.

The B.E.P.S. Action Plan has identified treaty abuse, and particularly treaty shopping, as one of the most important sources of base erosion and profit shifting. The Final Recommendations on Action Item 6[14] make a distinction between two types of treaty abuse:

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

Recommended Action

In order to address treaty shopping arrangements, the O.E.C.D. recommends a treaty-based solution and the following amendments to the Model Tax Convention:

- Inclusion in the title and preamble of tax treaties of a clear statement that the contracting states, when entering into a treaty, intend to avoid creating opportunities for nontaxation or reduced taxation.
- Inclusion in tax treaties of a specific anti-abuse rule based on the limitation on benefits ("L.O.B.") provisions, as are already provided in treaties concluded by the United States and a few other countrie.
- Addition to tax treaties of a more general anti-abuse rule ("G.A.A.R") based on the principal purpose test ("P.P.T.") to address other forms of treaty abuse.[15]

The L.O.B. clause provides a relatively objective basis for establishing a nexus between treaty benefits and entities having a relationship with the resident country. However, some commentators pointed out that non-collective investment vehicle ("non-C.I.V.") funds[16] would not qualify under the L.O.B. rules, as they do not meet any of the proposed requirements.[17] Regarding their particular activity, discussions are taking place to determine whether these non-C.I.V. funds should qualify *per se* under the L.O.B. provisions or whether a genuine diversity-of-ownership test should apply under which each investor must meet an L.O.B. test separately.[18]

Since the L.O.B. clause might not catch all "conduit arrangements," a G.A.A.R provision should be included in future tax treaties to deny benefits "if it is reasonable to

---

[14] O.E.C.D. (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

[15] *Id.*

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

[17] O.E.C.D. (2015), *Revised Discussion Draft, B.E.P.S. Action 6: Prevent Treaty Abuse*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

[18] O.E.C.D. (2016), *Public Discussion Draft, Treaty Entitlement of Non-C.I.V. Funds*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing.

> “The scope of G.A.A.R. could lead to legal uncertainties. In particular, holding and financing activities, even though constituting genuine business activities, may fall within this scope.”

conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.”[19]

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

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

> [A] national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.[20]

Thus, the report recognizes that flexibility may be required in the adoption of the suggested rules in relation to domestic anti-abuse regimes, constitutional issues, policy choices, and E.U. laws.[21]

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

The second type of abuse analyzed by Action Item 6 addresses situations where treaties prevent the application of specific domestic laws targeting abuses such as domestic G.A.A.R., thin capitalization, C.F.C. diversions of income, exit or departure taxes, and similar provisions. Aside from the inclusion of new commentaries in the O.E.C.D Model Tax Convention on these issues and in relation to the new P.P.T. rule aimed at maintaining the application of domestic anti-avoidance rules, Action Item 6 introduces in tax treaties a “saving clause” that confirms the Contracting States’ right to tax their residents according to their domestic law, notwithstanding the provisions of the tax treaty. As the O.E.C.D. pointed out, such a provision could clearly lead to double taxation and thus, would require further work in the first part of 2016. Additionally, Action Item 6 addresses the issue of exit or departure taxes by confirming that clarification will be made to the commentary on the O.E.C.D. Model Tax Convention to maintain domestic application.

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

---

19 O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*.

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

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

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

Scope of the M.L.I.

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

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

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

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

Main Provisions of the M.L.I.

Hybrid Mismatches

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

Transparent Entities

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

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

Dual Resident Entities

In cases where a party other than an individual is a resident of both Contracting States, Article 4 of the M.L.I. provides that the competent authorities must determine the residence of the person by mutual agreement using a tie-breaker that takes into account the place of effective management, the place of incorporation, and any other relevant factors. In the event that no mutual agreement can be reached, the party is not entitled to any tax relief or exemption provided by the tax treaty, except to the extent that and in such a manner as is agreed upon by the competent authorities.

Elimination of Double Taxation

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

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

Treaty Abuse

Minimum Standards

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

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

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

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

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

- A P.P.T.
- A P.P.T. and an L.O.B. provision
- A detailed L.O.B. provision supplemented by a mechanism to deal with conduit arrangements not already addressed in the treaty

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

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

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

Dividend Transfer Restriction

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

Capital Gains Derived Indirectly from Real Estate

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

According to Article 13(4) of the O.E.C.D. Model Tax Convention, gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other state. In order to avoid situations where assets are contributed to an entity shortly before a sale of its shares or comparable interests in order to dilute the proportion of the entity's value that is derived from immovable property, the M.L.I. (i) introduces a testing period for determining whether the value threshold is met, and (ii) expands the scope of covered interests to include interests comparable to shares, such as interests in a partnership or trust. Accordingly, the relevant provisions allowing the source state to tax such capital gains may continue to apply if the relevant value threshold is met at any time during the 365 days preceding the alienation, and may apply not only to shares but also to comparable interests, such as interests in a partnership or trust.

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

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

Saving Clause

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

Avoidance of Permanent Establishment Status

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

Commissionaire Arrangements

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

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

This amendment is optional for the Contracting States.

Specific Activity Exemptions

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

This amendment is optional for the Contracting States.

Splitting-Up of Contracts

According to the O.E.C.D.'s Final Report on Action Item 7, the segmentation of contracts is another potential strategy for the artificial avoidance of permanent establishment status. The M.L.I. therefore amends the existing 12-month threshold for determining the existence of a permanent establishment to take into account any activities carried out by an enterprise in a jurisdiction during one or more periods of time, which when aggregated, exceed 30 days within the 12-month threshold.

"Considering the M.L.I.'s flexibility and various available options, it is possible that its application will be highly complex and lead to uncertainty."

Dispute Resolution and Arbitration

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

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

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

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

Reservations

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

Timing

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

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

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

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

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

Conclusion

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

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

CONCLUDING REMARKS ON THE E.U.'S ACTION

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

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

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

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

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

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

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

Author
Matthias Scheifele
Hengeler Mueller
Frankfurt, Germany

The author would like to acknowledge the contribution of Yasmin Holm, also of Hengeler Mueller, in the preparation of this section.

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

STATE AID

Legal Framework and Definition of "State Aid"

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

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

Even if a measure meets the foregoing criteria, to be considered State Aid within the meaning of Article 107 §1 T.F.E.U., it may not be unlawful if one of the exemptions provided in Article 107 §§2 or 3 T.F.E.U. applies. For example, State Aid may be compatible with the internal market if it has a social character and is granted to individual consumers, eliminates damages caused by natural disasters, or is specific in relation to the former division of the Federal Republic of Germany.[5] In addition, the

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

[2] State Aid and Direct Business Taxation, ¶9.

[3] *Id.*, ¶11.

[4] *Jestaed* in Heidenhain, European State Aid Law, 2010, §8 ¶9.

[5] Consolidated Version of the Treaty on European Union art. 107, 2012 O.J. C 326/47, §2 [hereinafter "T.F.E.U."].

following may also be considered to be compatible with the internal market:[6]

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

Article 108 §3 T.F.E.U. provides that if a Member State intends to implement a new State Aid measure, it must notify the Commission. Pursuant to Article 108 §1 T.F.E.U., existing State Aid measures are constantly reviewed by the Commission. However, the T.F.E.U. contains neither detailed provisions regarding the notification procedure nor the review of existing State Aid or the recovery of unlawful State Aid. However, Article 109 T.F.E.U. authorizes the Council (upon proposal by the Commission and after consulting the Parliament) to implement regulations deemed appropriate regarding the application of the State Aid provisions, which the Council did in adopting Council Regulation 2015/1589/E.U. (the "Procedural Regulation").[12]

Pursuant to the Procedural Regulation, the Commission decides whether a proposed measure constituting State Aid is compatible with the internal market.[13] After notice but prior to the Commission's authorization, proposed State Aid measures should not be put into effect.[14] If the Commission finds that existing State Aid is incompatible with the internal market, it must decide whether the Member State granting the State Aid should amend or abolish the measure within a period of time as determined by the Commission.[15] State Aid must be recovered from the beneficiary unless the recovery of the aid would be contrary to a general principle of E.U. law.[16]

Application of State Aid Rules to Direct Business Taxation

The principle of incompatibility of State Aid with the internal market applies to aid

---

6 *Id.*

7 *Id.*, §3(a).

8 *Id.*, §3(b). In particular, this exemption was of importance in the context of the financial crises. See also *Blumenberg/Kring*, IFSt Nr. 473, 2011, p. 21(f).

9 *Id.*, §3(c).

10 *Id.*, §3(d).

11 *Id.*, §3(e).

12 Council Regulation 2015/1589/E.U. on the Application of Article 108 of the T.F.E.U. (codification), 2015 O.J. L 248/9 [hereinafter the "Procedural Regulation"].

13 *Id.*, art. 9.

14 *Id.*, art. 3.

15 T.F.E.U., art. 108, §2.

16 Procedural Regulation, art. 16, §1.

"in any form whatsoever."[17] As a consequence, national provisions regarding direct business taxation may be considered State Aid if the definitional criteria of the T.F.E.U. are met. In 1998, the Commission clarified these criteria with respect to national tax provisions in the Commission Notice on the application of State Aid rules to measures relating to direct business taxation.[18]

Economic Benefit

According to the Commission Notice, a tax measure grants an economic benefit within the meaning of Article 107 §1 T.F.E.U. if it relieves the beneficiary of charges it normally should bear. For instance, an advantage could be provided through a reduction in the tax base by special deductions or depreciation or by setting up reserves in the balance sheet. Tax exemptions, tax credits, deferred payment of taxes, and the cancellation of tax debt are examples of economic benefits that could also be considered advantages.[19] In a 2016 notice, the Commission especially addressed advantages in the form of (i) preferential tax regimes for cooperative societies, (ii) special tax rules governing investment funds, (iii) tax amnesties, (iv) tax rulings and settlements, (v) depreciation and amortization rules, (vi) fixed basis tax regimes for specific activities, (vii) exceptions from anti-abuse-rules, and (viii) excise duties.[20]

Benefit Through State Resources

With respect to taxes, an economic benefit can be identified as having been provided by state resources if the tax measure results in a loss of tax revenue that is equivalent to fiscal expenditures funded by state resources.[21] This applies even if the tax-related State Aid may have an indirect positive overall effect on budget revenue.[22] State support need not be provided only by legislation. It may be provided through the practices of tax authorities.[23]

Negative Impact on Trade and Competition

Tax measures affect trade and competition if the beneficiary carries on an economic activity that also involves trade between Member States. State Aid tax measures will be viewed as having a negative impact if they strengthen the beneficiary's position in relation to its competitors.[24]

Selectivity

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

---

17 State Aid and Direct Business Taxation, ¶2.

18 *Id.*, *et seq.*

19 *Id.*, ¶9.

20 State Aid in the T.F.E.U., ¶156 *et seq.*

21 State Aid and Direct Business Taxation, ¶10.

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

23 State Aid and Direct Business Taxation, ¶10.

24 *Id.*, ¶11.

“The determination of tax rates, depreciation rules, and rules regarding tax loss carryforwards do not constitute State Aid due to their equal application to all economic participants in a Member State.”

Direct business taxation provisions are only selective if they favor certain undertakings on an exclusive basis. This is not the case if the scope of a tax provision covers all undertakings in a Member State and all of these undertakings have effective access to the provision, since the scope of the tax measure would not be reduced by way of discretionary decisions or similar factors.[25] Pursuant to this principle, the determination of tax rates, depreciation rules, and rules regarding tax loss carryforwards do not constitute State Aid due to their equal application to all economic participants in a Member State.[26] Even the fact that these generally-applicable tax incentives provide a relatively higher benefit to some undertakings does not automatically cause a tax measure to be considered State Aid.[27]

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

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

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

Recovery of Unlawful State Aid

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

25 *Id.*, ¶13.

26 *Id.*

27 *Id.*, ¶14.

28 *Id.*, ¶16.

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

30 State Aid and Direct Business Taxation, ¶16.

31 *Id.*, ¶24-25.

32 *Id.*, ¶23.

The Commission may only refrain from requiring the recovery of unlawful State Aid in two defined cases. Article 14 §1 of the Procedural Regulation provides that no recovery will be required if it would be contrary to a general principle of E.U. law. These general principles provide for an exemption if, for instance, the recovery is absolutely impossible,[33] or if the protection of the doctrine of legitimate expectation overrides the need for recovery.[34] These exemptions are rarely applicable. Further, the recovery of unlawful State Aid is subject to a limitation period of ten years.[35]

Apart from theses exceptions and pursuant to Article 16 §1 of the Procedural Regulation, Member States must take all necessary measures to recover the unlawful State Aid from the beneficiary, including interest on the deferred payment.[36] The recovery must be executed immediately and is subject to the national law of the concerned Member State, provided that its national provisions allow the immediate and effective execution of the recovery.

According to case law decided by the E.C.J., national procedural law must be interpreted in a way that does not negatively affect the enforcement of E.U. law (known as the "Supremacy of Community Law").[37] Therefore, national rules providing that an administrative decision cannot be appealed after the expiration of a limitation period[38] or that suspend the effect of the Commission's decision for recovery are not applicable and will not override the obligation to obtain a refund of unlawful State Aid.[39]

Illustrative Examples

In the past few years, tax provisions have been subject to increasingly rigorous scrutiny as to whether they constitute State Aid. Investigations in the context of international business taxation suggest that the Commission views aggressive tax planning and tax base erosion by large multinationals as examples of State Aid.[40] Targets of these investigations include aid to (i) Apple granted by Ireland,[41] (ii) Starbucks granted by the Netherlands,[42] and (iii) Fiat granted by Luxembourg.[43]

In those cases, the Commission decided that Luxembourg and the Netherlands granted selective tax advantages to Fiat and Starbucks, respectively, by way of tax

---

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

34 *Id.*, §32, ¶24.

35 Procedural Regulation, art. 17, §1.

36 *Id.*, art. 16, §2.

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

38 *Id.*, ¶38.

39 *Commission v. France*, Case C-232/05, [2006] E.C.R. I-10071.

40 Commission Press Release, IP/14/663 (Jun. 11, 2014).

41 Commission Decision (*State Aid to Apple*), C(2016) 5605 Final (Aug. 2016). See also *Ireland v. Commission*, Case T-778/16 (pending case); *Apple Sales International and Apple Operations Europe v. Commission*, Case T-892/16 (pending case).

42 Commission Decision No. 2017/502/E.U. (*State Aid to Starbucks*), 2015 O.J. L 83/38. See also *Netherlands v. Commission*, Case T-760/15 (pending case); *Starbucks and Starbucks Manufacturing Emea v. Commission*, Case T-636/16 (pending case).

43 Commission Decision No. 2016/2326/E.U. (*State Aid to Fiat*), 2015 O.J. L 351/1. See also *Fiat Chrysler Finance Europe v. Commission*, Case T-759/15 (pending case); *Luxembourg v. Commission*, Case T-755/15 (pending case).

rulings which confirmed transfer pricing arrangements. These rulings qualify as State Aid because the calculation of intercompany prices did not comply with market terms. By approving the arrangements, the states afforded an economic benefit to the companies, but not their competitors, which allowed the companies to allocate profits to low-tax jurisdictions. In its decisions, the Commission set out the methodology to be used to calculate the value of the undue competitive advantage enjoyed by Fiat and Starbucks, *i.e.*, the difference between what the company paid and what it would have paid without the tax ruling. This amount was estimated to be between €20 million and €30 million for each company. The precise amount of tax to be recovered must now be determined by the Luxembourg and Dutch tax authorities.[44]

In the case of Apple, on the other hand, the Commission argued that the transfer prices used were negotiated with Irish tax authorities rather than substantiated by reference to comparable market transactions, and therefore the ruling does not reflect the arm's length principle under appropriate guidance for transfer pricing.[45] By allowing an unsubstantiated transfer pricing plan, Ireland may have granted a selective benefit to Apple by lowering its total tax burden.[46]

"In practice, the actual recorded profit of companies participating in this [excess profit] scheme was often reduced by more than 50%, and in some cases, up to 90%."

Another example is the in-depth investigations opened by the Commission in February 2015 regarding the Belgian excess profit ruling scheme.[47] Pursuant to Belgium's national tax regulations, multinational companies were allowed to reduce their tax base for alleged "excess profit" on the basis of a binding tax ruling. Under such tax rulings, the actual recorded profit of a multinational was compared with the hypothetical average profit that a stand-alone company in a comparable situation would have made. The alleged difference in profit was deemed to be excess profit by the Belgian tax authorities, and the multinational's tax base was reduced proportionately. In practice, the actual recorded profit of companies participating in this scheme was often reduced by more than 50%, and in some cases, up to 90%.[48] The Commission stated that Belgium provided a select number of multinationals substantial tax advantages in violation of E.U. State Aid rules. It ruled that the scheme distorted competition on the merits by putting smaller competitors on an unequal footing.[49] The Commission Decision required Belgium to stop applying the excess profit scheme and to recover the full unpaid tax from the at least 35 multinational companies that benefitted from the illegal scheme (around €700 million).[50]

In February 2016, the General Court ("E.G.C.") confirmed the Commission Decision[51] that the so-called "restructuring relief" clause under German corporate tax law that enabled an ailing company to offset its losses in a given year against profits in future years, despite changes in its shareholder structure, amounts to State Aid.[52] The clause departed from the general principle in the corporate tax law of Germany that prevented the carryforward of losses for fiscal purposes precisely when there

---

44 *State Aid to Fiat*, 2015 O.J. L 351/1; *State Aid to Starbucks*, 2015 O.J. L 83/38.

45 *State Aid to Apple*, C(2016) 5605 Final.

46 *Id.*

47 Commission Press Release, IP/16/42 (Jan. 11, 2016).

48 *Id.*

49 *Id.*

50 *Id.*

51 Commission Decision No. 2011/527/E.U. (*Sanierungsklausel*), 2011 O.J. L 235/26.

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

has been a significant change in the shareholding structure of the company concerned. The restructuring relief therefore favored ailing companies over financially-sound competitors that suffer losses in a given year. For those competitors, the tax benefit of a carryforward is not allowed when a significant change occurs in their shareholder structure. The clause therefore distorts competition in the single market. The German authorities' view was that the clause was merely a new technical feature of the German tax system, and for that reason, could therefore escape qualification as State Aid. This argument convinced neither the Commission nor the E.G.C.[53]

One of the latest rulings of the E.C.J. relates to a Spanish provision under which goodwill could be deducted when a Spanish-resident corporation acquired a shareholding in a foreign company equal to at least 5%.[54] No tax deduction for goodwill was granted when acquiring a shareholding in a domestic company. Even though the E.C.J. remitted the decision to the E.G.C., the ruling gave clear instruction on how the E.C.J. defines selectivity: A measure that places one undertaking in a position that is more favorable than that of another undertaking, although both undertakings are in a comparable factual and legal situation, may be viewed as selective.[55] There is no need to identify certain specific features that characterize a group of undertakings that are beneficiaries to the tax advantage.[56]

TRANSPARENCY MEASURES

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

Current Measures

Currently, Council Directive 2011/16/E.U. (the "Administrative Cooperation Directive"), as amended,[57] lays down the provisions for the cooperation of Member States in the exchange of information that may be relevant to the administration of domestic tax law. Pursuant to this Directive, Member States are obligated to share information that is foreseeably relevant to the administration of all taxes (except for V.A.T. and customs duties, excise duties, and compulsory social contributions) of another Member State in three different situations.[58]

Mandatory Automatic Exchange of Information

The tax authorities of a Member State must communicate any available information

53 Appeal proceedings before the E.C.J. (Case C-219/16 P) are pending.

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

55 *Id.*, ¶79.

56 *Id.*, ¶78.

57 Council Directive 2011/16/E.U. on Administrative Cooperation in the Field of Taxation, 2011 O.J. L 64/1 [hereinafter the "Administrative Cooperation Directive"], amended by Council Directive 2014/107/E.U., 2014 O.J. L 359/1; Council Directive 2015/2376/E.U., 2015 O.J. L 332/1; and Council Directive 2016/881/E.U., 2016 O.J. L 146/8.

58 Administrative Cooperation Directive, art. 2, §2.

regarding taxable periods beginning on or after January 1, 2014 concerning residents in another Member State relating to income from

- employment,
- director's fees,
- life insurance,
- pensions, and
- the ownership of and income from immovable property.

Council Directive 2014/107/E.U. of December 9, 2014 significantly expanded the scope of information that must be transmitted on a mandatory basis. Pursuant to the amended Administrative Cooperation Directive, Member States must communicate personal data with respect to custodial and depository accounts, the account balance as of the end of a calendar year, and the total gross amount of interest, dividends, and gains from the disposal of financial assets credited to the concerned account.[59]

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

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

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

Spontaneous Exchange of Information

Member States must also spontaneously communicate information in several expanded circumstances:

- The Member State supposes that there may be losses of tax in another Member State.
- A tax exemption or reduction in one Member State might give rise to an

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

increasing tax liability in another Member State.

- Business dealings between two persons are conducted in a way that might result in tax savings.

- The tax authority of a Member State supposes that tax savings may result from an artificial transfer of profits between groups of enterprises.

- Information forwarded to a Member State has enabled information to be obtained which might be relevant for taxation in the other Member State.[60]

Exchange of Information on Request

Member States must exchange information on taxes that may be relevant to another Member State upon request of the other Member State.[61]

Country-by-Country Reporting

The amendment of the Administrative Cooperation Directive by Council Directive 2016/881/E.U. of May 25, 2016[62] introduced rules requiring multinational companies to report certain tax-related information and the exchange of that information between Member States. Under the new rules, multinational groups of companies located in the E.U. or with operations in the E.U. having a total consolidated revenue equal to or greater than €750 million will be obligated to file a Country-by-Country Report. The competent national authority that receives the CbC Report must communicate the report by automatic exchange to any other Member State in which one or more constituent entities of the multinational group are either resident for tax purposes or are subject to tax with respect to business carried out through a permanent establishment. The CbC Report is filed in the Member State in which the ultimate parent entity of the group or any other reporting entity is a resident for tax purposes. The report must include the following information for every tax jurisdiction in which the group is active:

- Amount of revenue

- Profit (loss) before income tax

- Income tax paid (on cash basis)

- Income tax accrued (current year)

- Stated capital

- Accumulated earnings

- Number of employees

- Tangible assets other than cash and cash equivalents

---

60 *Id.*, art. 9, §1.

61 *Id.*, art. 5.

62 *Supra* note 57. The directive is the first element of a January 2016 package of Commission proposals to strengthen rules against corporate tax avoidance. The directive builds on the 2015 O.E.C.D. recommendations to address base erosion and profit shifting and will implement O.E.C.D. B.E.P.S. Action 13, on country-by-country reporting by multinationals.

In general, CbC Reports must be provided within 15 months of the last day of the fiscal year of the reporting multinational group. The rule is somewhat different for the first CbC Reports. The first reports must relate to the reporting group's fiscal year commencing on or after January 1, 2016, and must be submitted within 18 months of the last day of that fiscal year.[63]

Germany implemented the provisions relating to CbC Reporting and the automatic exchange of cross-border tax rulings and advance pricing arrangements into law on December 20, 2016.[64]

Tax Transparency Package

As part of its efforts to tackle corporation income tax avoidance and harmful tax competition in the E.U.,[65] and certainly as a reaction to the State Aid investigations resulting from the tax rulings to multinationals,[66] the Commission presented a package of tax transparency measures in March 2015. Two of the proposals included in this package, *i.e.*, (i) the automatic exchange of information regarding cross-border tax rulings and advance pricing arrangements, (ii) and the CbC Reporting obligation, have already been implemented.[67]

Action Plan

On June 17, 2015, the Commission presented an Action Plan for Fair and Efficient Corporate Taxation in the E.U. that is partially tied into the tax transparency package.[68] Key actions include a plan to relaunch the Common Consolidated Corporate Tax Base ("C.C.C.T.B.")[69] and to establish of a framework to ensure effective taxation in the country where profits are generated (*e.g.*, modifications to the Code of Conduct for Business Taxation, and measures to close legislative loopholes, improve the transfer pricing system, and implement stricter rules for preferential tax regimes).[70] Moreover, the action plan has set out the next steps towards greater tax transparency within the E.U. and in other non-E.U. ("third country") jurisdictions (*i.e.*, a common approach to third-country non-cooperative tax jurisdictions and an assessment of further options).[71] The Commission also promoted greater cooperation between Member States in the area of tax audits.[72]

---

63 *Id.*, art. 1, ¶2.

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

65 Commission Press Release, IP/15/4610 (Mar. 18, 2015).

66 See **Public Tax Transparency Rules for Multinationals**, below.

67 See **Common Reporting Standards**, below.

68 Commission Communication to the European Parliament and the Council on a Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action, COM (2015) 302 Final (June 2015) [hereinafter "5 Key Areas"].

69 Commission Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 Final (Oct. 2016).

70 5 Key Areas, p. 7.

71 *Id.*, p. 12.

72 *Id.*, p. 14.

Public Tax Transparency Rules for Multinationals

On April 12, 2016, the Commission proposed the introduction of a requirement for multinational companies operating in the E.U. (both E.U. residents and non-E.U. residents) with global revenues exceeding €750 million a year to publish key information on where the profits are generated and where taxes are paid in the E.U. on a country-by-country basis. Aggregate figures would also have to be provided for operations in non-E.U. tax jurisdictions. In addition, contextual information (such as turnover, number of employees, and nature of activities) would have to be disclosed for every E.U. country in which a company is active, as well as for those tax jurisdictions that do not abide by tax good governance standards (*i.e.*, tax havens). The information will remain available for five years.[73] The proposal is undergoing the parliamentary process, facing some criticism.[74]

"The E.U. legal framework distinguishes between listed companies and companies in the legal form of limited liability companies or limited partnerships."

Common Reporting Standards

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

With respect to listed companies, Council Regulation 1606/2002/E.C., as amended,[75] grants the Commission the authority to adopt the International Financial Reporting Standards, the International Accounting Standards, and the related Interpretations ("S.I.C./I.F.R.I.C.-Interpretations") issued by the International Accounting Standards Board ("I.A.S.B.").[76] On this legal basis, the Commission adopted a set of international financial reporting standards by issuing Commission Regulation 1126/2008/E.C. (the "I.A.S. Regulation").[77] As a result, the international financial reporting standards are directly applicable in the domestic legislation of all Member States. If the I.A.S.B. issues new or amended standards or interpretations, the adoption of these new provisions follows a complex endorsement process.[78] Therefore, the I.A.S. Regulation is amended on a continuing basis.

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

---

73 Commission Proposal for a Directive Amending Council Directive 2013/34/E.U. on the Disclosure of Income Tax Information by Certain Undertakings and Branches, COM (2016) 198 Final.

74 See the suggested amendments to the Commission's proposal in the Council's statement of December 19, 2016, Interinstitutional File 2016/0107 (COD), document no. 15243/16.

75 Council Regulation 1606/2002/E.C. on the Application of International Accounting Standards, 2002 O.J. L 243/1 [hereinafter "Application of I.A.S."], as amended by Council Regulation 297/2008/E.C. on the Implementing Powers Conferred on the Commission, 2008 O.J. L 97/62.

76 Application of I.A.S., art. 2 and art. 3, §1.

77 Commission Regulation 1126/2008/E.C. Adopting Certain International Accounting Standards, 2008 O.J. L 320/1.

78 For further details regarding the endorsement process, see Application of I.A.S., art. 6, and Council Decision No. 1999/468/E.C., 1999 O.J. L 184/23, art. 5(a) and art. 8.

79 Council Directive 2008/22/E.C. on the Harmonization of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market, 2008 O.J. L 76/50 [hereinafter the "Transparency Directive"].

Prospectus Directive:[80]

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

Companies in the legal form of limited liability companies or in the legal form of partnerships, whose partners have limited liability, fall under the scope of the Accounting Directive.[84] The Accounting Directive requires these entities to present their annual financial reports in compliance with the general principles set forth in the directive. These provisions broadly cover an entity's balance sheets, profit and loss accounts, notes on financial statements, and management reports. In addition, the Accounting Directive requires the publication and disclosure of the required information and the audit of financial statements. With respect to small- and medium-sized enterprises, the Member States may apply optional exemptions to the regulatory requirements of the Accounting Directive to avoid excessive demands for those undertakings. The laws and provisions necessary to comply with the Accounting Directive must be effective as of July 20, 2015.[85]

In addition, a recently-issued directive requires large groups to report non-financial and diversity information. The affected companies will be obligated to publish information providing an understanding of the undertaking's development, performance, and position, the impact of its activity on environmental, social, and employee matters, and its respect for human rights and handling of anti-corruption and anti-bribery matters. The Member States were required to transfer these provisions into domestic law by December 6, 2016.[86]

Anti-Tax Avoidance Package

In January 2016, the Commission adopted an Anti-Tax Avoidance Package as part of its agenda for fair corporate taxation in Europe. The package contains concrete

---

80 Council Directive 2003/71/E.C. on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading, 2003 O.J. L 345/64 [hereinafter the "Prospectus Directive"].

81 Transparency Directive, Chapter II.

82 *Id.*, Chapter III.

83 Prospectus Directive, art. 5.

84 Council Directive 2013/34/E.U. on the Annual Financial Statements, Consolidated Financial Statements, and Related Reports of Certain Types of Undertakings, 2013 O.J. L 182/19 [hereinafter the "Accounting Directive"].

85 *Id.*, art. 53, §1.

86 See art. 4, §1 of Council Directive 2014/95/E.U. on the Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups, 2014 O.J. L 330/1, which amends the Accounting Directive.

measures to "prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the E.U."[87] One key element of this package is the Anti-Tax Avoidance Directive ("A.T.A.D."), which introduces six legally-binding anti-abuse measures that all Member States should apply against common forms of aggressive tax planning.[88]

General Interest Limitation Rule

Under the general interest limitation rule, borrowing costs will be deducted to the extent that the taxpayer receives interest or other taxable revenues from financial assets. The deduction of any exceeding borrowing costs will be limited to an amount of 30% of the taxpayer's earnings before interest, taxes, depreciation, and amortization or €3 million, whichever is higher.[89] The limitation applies without distinction as to the origin of the debt (*e.g.*, it is irrelevant whether the interest is related to intra-group, third-party, E.U., or third-country debt, or whether the lender is effectively taxed on such interest).

Member States have the option to introduce an override if a taxpayer can demonstrate that its ratio of equity to total assets is no more than two percentage points lower than the equivalent group ratio. An additional exception is allowed in cases where excessive borrowing costs are incurred on third-party loans used to fund certain public infrastructure projects. Borrowing costs that cannot be deducted in the current tax year can be carried forward into subsequent tax years without limitation, or can be carried back for three years. Excess interest capacity in any year can be carried forward for five years. Member States can postpone the implementation of the interest expense limitation rule, provided a national rule is in place preventing base erosion and profit shifting that provides a comparable result. The deferred implementation date cannot be later than January 1, 2024, and may be advanced in the event of an earlier implementation date in the comparable O.E.C.D. provision under the B.E.P.S. Action Plan.

Exit Taxation

The provision on exit taxation obliges Member States to apply an exit tax when a taxpayer relocates its assets or tax residence. Examples of this include a taxpayer who

- transfers assets from its head office to its permanent establishment in another Member State or in a third country;

---

[87] The key elements of the Anti-Tax Avoidance Package are (i) the Chapeau Communication, (ii) the Anti-Tax Avoidance Directive, (iii) the Administrative Cooperation Directive, (iv) the Recommendation on Tax Treaties, (v) the Communication on an External Strategy for Effective Taxation, and (vi) the Study on Aggressive Tax Planning; "Anti-Tax Avoidance Package." European Commission Taxation and Customs Union. January 2016.; c.f., Commission Communication to the European Parliament and the Council on the Anti-Tax Avoidance Package, COM (2016) 23 Final (Jan. 2016).

[88] Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1 [hereinafter "A.T.A.D."], amended by Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

[89] This provision on the interest limitation rule is similar to the current German interest limitation rule.

- transfers assets from its permanent establishment in a Member State to its head office or another permanent establishment in another Member State or in a third country;
- transfers its tax residence to another Member State or to a third country, except for those assets which remain effectively connected with a permanent establishment in the first Member State; or
- transfers its permanent establishment out of a Member State.

A taxpayer may pay these exit taxes in installments over at least five years for transfers within the E.U. or the E.E.A.[90] Regarding a transfer involving an E.E.A. state, that state must have concluded an agreement on mutual assistance for the recovery of claims that complies with Council Directive 2010/24/E.U.[91]

Switch-Over Clause

As originally proposed, the A.T.A.D. included a switch-over clause that created an obligation for Member States to eliminate exemptions for foreign income not arising from an active business. Tainted circumstances include (i) profit distributions from an entity in a third country, (ii) proceeds from the disposal of shares held in an entity in a third country, or (iii) income from a permanent establishment situated in a third country with a substantially lower tax rate.

The Council agreed to eliminate the switch-over provision.

General Anti-Abuse Rule

Under the general anti-abuse rule ("G.A.A.R."), arrangements that are not put into place for valid commercial reasons reflecting economic reality, but are instead put into place for the main purpose (or one of the main purposes) of obtaining a tax advantage that defeats the object or purpose of an otherwise applicable tax provision will be ignored for the purposes of calculating the corporate tax liability. The tax liability will be calculated based on the definition of economic substance in accordance with relevant national law. G.A.A.R. is applicable to domestic as well as cross-border transactions.

Controlled Foreign Corporation Rules

The proposed controlled foreign company ("C.F.C.") rules re-attribute the income of a low-taxed C.F.C. to its parent company. This will be achieved by adding the undistributed income of an entity to the tax base of a taxpayer in the following cases:

- The taxpayer (together with its associated enterprises) holds (directly or indirectly) more than 50% of the voting rights or capital, or is entitled to receive more than 50% of the profits.
- Under the general regime in the country of the entity, profits are subject to an effective corporate tax rate lower than 50% of the effective tax rate that would have been charged under the applicable corporate tax system in the Member State of the taxpayer.

---

90 A.T.A.D., art. 5.

91 Council Directive 2010/24/E.U. Concerning Mutual Assistance for the Recovery of Claims Relating to Taxes, Duties, and Other Measures, 2010 O.J. L 84/1.

- More than one-third of the income of the entity comes from
    - interest or any other income generated by financial assets;
    - royalties or any other income generated from intellectual property or tradable permits;
    - dividends and income from the disposal of shares;
    - financial leasing;
    - immovable property, unless the Member State of the taxpayer would not have been entitled to tax the income under an agreement concluded with a third country;
    - insurance, banking, and other financial activities; or
    - services rendered to the taxpayer or its associated enterprises.
- The entity is not a company whose principal class of shares is regularly traded on one or more recognized stock exchanges.

"A hybrid mismatch results from two jurisdictions giving different legal characterization to a business form."

Undistributed income of a C.F.C. will be included in a taxpayer's home country income. Member States may adopt one of two approaches for computing the inclusion.

The tainted undistributed income listed above is fully included in a shareholder's income, subject to an exception for the undistributed income of a C.F.C. that carries on a substantive economic activity supported by staff, equipment, assets, and premises. Members exclude this active business exception if the C.F.C. is not a resident of an E.U. Member State or an E.E.A. State.

All undistributed income from non-genuine arrangements are included in a shareholder's income if obtaining a tax advantage is an essential purpose of the arrangement. Whether an arrangement is non-genuine is determined by reference to the staffing and performance of persons assigned to the C.F.C. or by the persons of the controlling company. The income to be included is based on the value of the functions performed by the staff of the controlling company. A *de minimis* rules applies so that companies with accounting profits that do not exceed €750,000 and non-trading income that does not exceed €75,000 are not covered by the C.F.C. rule.

Hybrid Mismatches

A hybrid mismatch results from two jurisdictions giving different legal characterization to a business form – *viz.*, whether a permanent establishment exists – or a business transaction – *viz.*, whether a payment is deductible interest or dividends paid on a participation. This may lead to a situation where

- a deduction of the same payment, expenses, or losses occurs both in the jurisdiction in which the payment has its source, the expenses are incurred, or the losses are suffered, and in another jurisdiction (double deduction);
- a deduction of a payment occurs in the jurisdiction in which the payment has its source without a corresponding inclusion of the same payment in another jurisdiction (deduction without inclusion); or

- no taxation occurs on income in its source jurisdiction without inclusion in another jurisdiction (nontaxation without inclusion).

Where a double deduction exists between two Member States, a deduction will be allowed only in the Member State where the payment has its source. In relation to third countries, the Member State generally denies the deduction. Where there is a deduction without inclusion between two Member States, no deduction will be allowed. In relation to third countries, the Member State denies the deduction if it is the source jurisdiction, and, generally, it includes the payment in its tax base if the third country is the source jurisdiction. Where nontaxation without inclusion exists, the jurisdiction where the business is resident includes the income in its tax base.

In addition, the hybrid mismatch provision also addresses situations in which two jurisdictions give different legal characterizations to the same financial instrument. The provisions apply in cases where a financial instrument is transferred and the underlying return is treated as derived simultaneously by more than one of the parties, who are resident for tax purposes in different jurisdictions, leading to

- a deduction of a payment connected with the underlying return without a corresponding inclusion, or

- relief from tax withheld at the source on payments derived from the transferred financial instrument to more than one of the parties involved.

CONCLUSION

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

LUXEMBOURG

Author
Mélanie Staes
Loyens & Loeff
New York, U.S.A.

Over the last few decades, Luxembourg has been extremely popular as a holding and financing jurisdiction for both E.U. and non-E.U. investors. Its position as an important financial center and the professional environment it offers, combined with advantageous tax treatment and corporate flexibilities, give Luxembourg a leading role worldwide in investment funds and as a preferred European jurisdiction for holding, financing, and private wealth management activities.

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

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

A S.O.P.A.R.F.I. should be distinguished from a *société de gestion de patrimoine familial regime* ("S.P.F."), as an S.P.F. is fully exempt from Luxembourg corporate income and withholding taxes and is neither eligible for protection under the Luxembourg bilateral tax treaties nor covered by the E.U. tax directives.

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

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

Second, in July 2016, a new regime was introduced for reserved alternative investment funds ("R.A.I.F.") in response to the need of alternative investment fund ("A.I.F.") managers and investors for lighter establishment guidelines and more flexible corporate and operating regulations.

Finally, a legal and regulatory framework applies to securitization vehicles ("sociétés de titrisation") coupled with a favorable tax regime. The S.I.C.A.R., the R.A.I.F., and the securitization vehicles will be dealt with below in **S.I.C.A.R.**, **R.A.I.F.**, and **Securitization Vehicles**, respectively.

GENERAL/PARTICIPATION EXEMPTION

A S.O.P.A.R.F.I. established in the city of Luxembourg is subject to Luxembourg income tax at a combined top rate of 27.08% as of January 1, 2017. This rate includes the national corporation income tax ("C.I.T."), plus the Luxembourg City municipal business tax, and a 7% unemployment fund surcharge. As of January 1, 2018, the combined top rate will be reduced to 26.01% in Luxembourg City.

As of January 1, 2016, the fixed minimum C.I.T. for a S.O.P.A.R.F.I. has been abolished and replaced by a minimum net wealth tax, which is largely similar to the minimum corporate tax. As of January 1, 2017, the minimum net wealth tax for a S.O.P.A.R.F.I. has been increased from €3,210 to €4,815. See **Annual Net Worth Tax** for further details.

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

Dividends

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

(a) The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax-transparent entity), or the participation has an acquisition cost of at least €1.2 million;

(b) The subsidiary is a collective entity or a company with capital divided into shares and is (i) an entity falling within the scope of Article 2 of the E.U. Parent-Subsidiary Directive (2011/96/E.U.), as amended from time to time, (the "P.S.D.") or a permanent establishment thereof, (ii) a fully taxable Luxembourg entity not falling in the scope of the annex to Paragraph 10 of Article 166 I.T.A. (which is a copy of the annex to the P.S.D.), or (iii) a company subject in its country of residence to a profit tax comparable to Luxembourg's C.I.T. in terms of rate and taxable basis (see below for recent limitations to the P.S.D.); and

(c) At the time of distribution, the S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, the participation for an uninterrupted period of at least 12 months, and during this period, its interest in the subsidiary may not drop below the threshold mentioned above (10% or an acquisition cost of €1.2 million).

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

Regarding the second condition described above, *i.e.*, the implementation of the P.S.D. in Luxembourg, it is noted that in July and December 2014, the P.S.D. was amended to include a provision countering hybrid loan arrangements and

“The hybrid loan provision aims at preventing double nontaxation via the use of hybrid financing arrangements by limiting the exemption of payments.”

implementing a general anti-abuse rule (“G.A.A.R.”).[1] The hybrid loan provision aims at preventing double nontaxation via the use of hybrid financing arrangements by limiting the exemption of payments received through such arrangements if such payment is deducted in another E.U. Member State. The anti-abuse provision requires E.U. Member States to refrain from granting the benefits of the P.S.D. to certain arrangements that are not “genuine.” In addition, one of the main purposes of the arrangement must be to obtain a tax advantage that would defeat the object or purpose of the P.S.D. E.U. Member States, including Luxembourg, had to ensure that their domestic tax rules were aligned with the revised P.S.D. by January 1, 2016. By law as of December 18, 2015, the Luxembourg participation exemption (and withholding tax exemption) rules have been amended, effective as of January 1, 2016, to be in line with the revised P.S.D. Therefore, dividends received by a Luxembourg taxpayer from a subsidiary in the E.U. (including in principle Luxembourg subsidiaries) are no longer exempt if they are deductible by the E.U. subsidiary distributing the dividend. In addition, when the P.S.D.-based participation exemption is applied, G.A.A.R. needs to be tested before an exemption is available. G.A.A.R. should not apply to distributions from a Luxembourg company to another Luxembourg company that is normally subject to tax.

As set out above, the Luxembourg domestic participation exemption may still be available, and testing under G.A.A.R. may not be required, if the subsidiary meets the comparable tax test as referred to under the third condition described above and further detailed in **Capital Gains** below in the context of an income tax treaty, which should be the case for many E.U. Member State subsidiaries.

Capital Gains

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

- The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax-transparent entity), or the participation has an acquisition cost of at least €6 million;
- The subsidiary is (i) an entity falling within the scope of Article 2 of the P.S.D. or a permanent establishment thereof, (ii) a fully taxable Luxembourg entity not falling in the scope of the annex to Paragraph 10 of Article 166 I.T.A., or (iii) a company subject in its country of residence to a profit tax comparable to the Luxembourg C.I.T. in terms of rate and taxable basis (see below); and
- The S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, a minimum participation, as mentioned above, for an uninterrupted period of at least 12 months.

The capital gains exemption is not subject to G.A.A.R. as implemented in Luxembourg

[1] Proposal for a Council Directive amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States - Political Agreement, COM(2013) 814 Final; see also: Council Directive 2014/86/E.U. amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 2014 O.J. L 219/40.

law following the amendments to the P.S.D., as the latter only relates to dividends and not capital gains.

SUBJECT TO TAX

As outlined above, in order to qualify for the Luxembourg participation exemption on dividends and capital gains, nonresident subsidiaries should either qualify under Article 2 of the P.S.D. or must be subject to a comparable tax in their country of residence.

Based on parliamentary documents, this requirement is to be understood as follows: A foreign corporation income tax is comparable if it is levied at a rate of at least 9.5% (9% as from 2018) and the tax basis is computed on a basis that is similar to that which would be used in Luxembourg. No list of qualifying countries for this purpose exists. Where comparability is subject to doubt, an advance tax agreement ("A.T.A.") can be requested from the Luxembourg tax authorities.

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

DIVIDENDS OR CAPITAL GAINS AFTER SHARE EXCHANGE

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

- Conversions of a loan whereby securities representing share capital of the debtor are issued to the creditor;
- Transformations of a capital company into another capital company whereby securities of the transformed company are issued to the shareholder;
- Mergers or divisions of capital companies or companies resident in an E.U. Member State whereby securities of the merged company are issued to the shareholder of the disappearing company; and
- Certain other share-for-share exchange transactions.

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

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

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

LUXEMBOURG PERMANENT ESTABLISHMENT

The participation exemption also applies to dividends received and gains realized on participations that are attributed to a Luxembourg permanent establishment of a resident of an E.U. Member State or of a country where it is subject to tax (refer to **Subject to Tax** above).

PARTIAL PARTICIPATION EXEMPTION

An interest of less than 10% in a subsidiary with an acquisition cost of less than €1.2 million and/or an interest in a subsidiary for which the 12-month holding-period requirement is not and will not be met will not qualify for the participation exemption described above. However, dividend income derived from such interests may nevertheless be eligible for a 50% exemption, provided that such dividends were distributed by (i) a fully taxable Luxembourg capital company, (ii) a capital company resident in a treaty country which is subject to a profit tax comparable to the Luxembourg C.I.T., or (iii) a company resident in an E.U. Member State and falling within the scope of Article 2 of the P.S.D.

WITHHOLDING TAX IN A FOREIGN SUBSIDIARY'S COUNTRY

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

As of the date of this article, Luxembourg has 79 income tax treaties in force with the following jurisdictions:

Andorra	Armenia	Austria	Azerbaijan
Bahrain	Barbados	Belgium	Brazil
Brunei	Bulgaria	Canada	China
Croatia	Czech Republic	Denmark	Estonia
Finland	France	Georgia	Germany
Greece	Guernsey	Hong Kong	Hungary
Iceland	India	Indonesia	Ireland
Isle of Man	Israel	Italy	Japan
Jersey	Kazakhstan	Laos	Latvia
Liechtenstein	Lithuania	Macedonia	Malaysia
Malta	Mauritius	Mexico	Moldova
Monaco	Morocco	Netherlands	Norway
Panama	Poland	Portugal	Qatar

Romania	Russia	San Marino	Saudi Arabia
Serbia	Seychelles	Singapore	Slovakia
Slovenia	South Africa	South Korea	Spain
Sri Lanka	Sweden	Switzerland	Taiwan
Tajikistan	Thailand	Trinidad & Tobago	Tunisia
Turkey	United Arab Emirates	United Kingdom	United States
Uruguay	Uzbekistan	Vietnam	

Additionally, Luxembourg is in the process of ratifying 17 income tax treaties, six of which are still being negotiated. Of those 17, one is a protocol being negotiated and 16 are either new treaties or existing treaties being renegotiated.

Luxembourg has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

DEDUCTION OF COSTS

Value Adjustments

A S.O.P.A.R.F.I. may make deductible value adjustments on a participation. The deductions can be used to offset other income (such as income from financing activities or commercial activities) and may result in tax losses. Losses that were incurred before 2017 may be carried forward indefinitely. However, losses that were incurred as of January 1, 2017 can be carried forward for 17 years after the losses occurred.

It should be noted that deductions made in previous years that are linked to exempt participations are recaptured in the event of a future disposition of the company. The capital gains exemption (as described in **Capital Gains**) does not apply to the extent of such previously-deducted expenses and value adjustments. As a result, capital gains arising from a disposition of shares may (in part) be taxable and offset by available losses carried forward.

"Currency exposure should be avoided, preferably by denominating such loans in the currency that the Luxembourg taxpayer applies as its functional currency."

Financial Costs

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

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

Realized currency gains and currency losses on loans obtained to finance the acquisition or further capitalization of subsidiaries are taxable or deductible. Therefore, currency exposure should be avoided, preferably by denominating such loans in the currency that the Luxembourg taxpayer applies as its functional currency. Currency gains on the investment in the participation itself and, in principle, on repayments of capital, are exempt due to the participation exemption. Currency losses on the investment and on repayments of capital are tax deductible but may fall under the recapture rules.

Liquidation Losses

A loss realized upon liquidation of a participation is deductible.

WITHHOLDING TAX ON OUTBOUND DIVIDENDS AND CAPITAL GAINS

Distributions on Shares

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

- An entity falling within the scope of Article 2 of the P.S.D., or a permanent establishment thereof;
- A fully-taxable Luxembourg entity not falling within the scope of the annex to Paragraph 10 of Article 166 I.T.A.;
- A Swiss-resident capital company that is subject to corporation tax in Switzerland without benefiting from an exemption; or
- A company resident in a treaty country and subject in that country to a profit tax comparable to the Luxembourg C.I.T. in terms of rate and taxable basis.

Such distributions are exempt from Luxembourg dividend withholding tax if the following conditions apply:

- The dividend is paid to a qualifying entity that holds 10% or more of the issued share capital of the Luxembourg company (whether via a tax-transparent entity or not), or the participation has an acquisition cost of at least €1.2 million.
- The qualifying entity has held, or commits itself to continue to hold, a minimum participation as mentioned above for an uninterrupted period of at least 12 months.[2]

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

As mentioned above (refer to **General/Participation Exemption** in this chapter), for dividends paid to shareholders referred to in the second bullet above, the anti-abuse rules of the P.S.D. as implemented in Luxembourg law should be tested and may prevent the application of the exemption. For the other type of shareholders, no such test is applicable.

Interest Payment on (Hybrid) Debt

Arm's length fixed or floating rate interest payments to Luxembourg and non-Luxembourg residents are not subject to Luxembourg withholding tax. However, interest

[2] In recent practice, prior to the completion of the 12-month holding period, the fulfillment of this requirement must be guaranteed by way of a commitment letter from the shareholder.

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 abolition of Directive 2003/48/E.C. on taxation of savings income in the form of interest payments, Luxembourg no longer withholds tax on certain savings income as of January 1, 2015, but now automatically exchanges information with E.U. Member States under the application of Directive 2011/16/E.U. in regard to the mandatory automatic exchange of information in the field of taxation.

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

In a European context, following the amendments made to the P.S.D. (referred to in **General/Participation Exemption**), the use of hybrid instruments may be limited where two E.U. Member States are concerned. In Luxembourg, however, so far no legislation has been implemented that would bar the deduction of interest paid on hybrid instruments issued by a Luxembourg company.

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

In this context, a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the Anti-Tax Avoidance Directive (2016/1164), or "A.T.A.D.") has been adopted. The main goal of the A.T.A.D. is to ensure a coordinated and coherent implementation at the E.U. level of some of the O.E.C.D.'s recommendations from the B.E.P.S. Action Plan and of certain anti-tax avoidance measures which are not part of the B.E.P.S. Action Plan. The measures to be implemented by E.U. Member States are the following:

- An interest deduction limitation rule
- Exit taxation
- A general anti-abuse rule
- Controlled foreign corporation ("C.F.C.") legislation
- Hybrid mismatch rules applicable to hybrids between E.U. Member States

The implementation date is January 1, 2019, except for the exit taxation provision (January 1, 2020) and the interest deduction limitation provision (January 1, 2024, subject to certain conditions). Certain components of the implementation of the A.T.A.D. will require changes to currently existing corporate income tax rules, such as interest deduction limitations, but others will also require the introduction of completely new sets of regulations in many E.U. Member States, including Luxembourg, such as those governing C.F.C.'s and hybrid mismatches.

In addition, a Council Directive laying down rules regarding hybrid mismatches with third countries (the Anti-Tax Avoidance Directive 2, or "A.T.A.D. 2") is currently in the process of being adopted. The latest draft of the A.T.A.D. 2 available at the date of this writing is dated May 19, 2017. The A.T.A.D. 2 would amend and extend the scope of the existing A.T.AD. rules to (i) a wide variety of other mismatches, and (ii) mismatches between E.U. Member States and third countries, by January 1, 2020 (January 1, 2022 for reverse hybrid mismatch rules). If approved, the proposals will have a substantial impact on structures relying on hybrid entities and instruments that are currently in use, as well as permanent establishments.

CAPITAL GAINS IN HANDS OF SHAREHOLDERS

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

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

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

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

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

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

OTHER TAX ISSUES

Debt-to-Equity Ratio

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

Capital Duty

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

Annual Net Worth Tax

A S.O.P.A.R.F.I. is subject to an annual net worth tax, which is levied at the rate of 0.5% of the company's worldwide net worth on January 1 of each year. On January 1, 2016, a reduced rate of 0.05% for taxable net wealth in excess of €500 million was introduced. The first €500 million of taxable net wealth remain taxable at 0.5%.

Certain assets are excluded, such as shares in a participation, provided that the participation exemption for dividend income, as described above in **General/Participation Exemption**, is applicable. However, with regards to the net worth tax exemption, there is no minimum holding period requirement.

Reference is also made to **General/Participation Exemption** in this chapter with respect to the minimum net wealth tax applicable as of January 1, 2016. To address criticism from the European Commission that the minimum C.I.T. might infringe on the P.S.D., the minimum C.I.T. has been replaced with a minimum net wealth tax and the already existing minimum net wealth tax was abolished, effective as of January 1, 2016. Until 2015, Luxembourg-resident corporate taxpayers were subject to either a contingent or fixed minimum corporation income tax. The fixed minimum net wealth tax as of January 1, 2017 is €4,815 (including the 7% surcharge), and is applied if, in a given year, the resident corporate taxpayer's financial assets exceeded 90% of its total balance sheet and those assets exceeded €350,000, which is the case for most holding and financing companies. In all other cases, the minimum tax is contingent on the balance sheet total of the resident corporate taxpayer, varying from €535 to €32,100 for a balance sheet total exceeding €30 million.

If a S.O.P.A.R.F.I. is part of a Luxembourg fiscal unity, both the parent company and the subsidiaries' part of the fiscal unity are subject to the minimum tax. However, the aggregate minimum tax payable by a fiscal unity is capped at €32,100. Each member of the fiscal unity is fully liable for its own minimum tax as well as for the minimum tax of the subsidiaries' part of the fiscal unity, including interest for late tax payments and penalties.

The fixed minimum tax is reduced by the C.I.T. (including the 7% surcharge) due for the preceding tax year. For the year 2016, however, the 2016 minimum net wealth tax can only be decreased with the 2015 corporation income tax insofar as the latter exceeds the amount of the minimum corporation income tax still due in 2015.

Advance Tax Agreements and Advance Pricing Agreements

As of January 1, 2015, the procedure to obtain an advance tax agreement ("A.T.A.")

has been codified into Luxembourg law. In an A.T.A., the Luxembourg tax authorities confirm the interpretation of the tax law as applied to the specific facts of the case presented by the taxpayer. Following submission, an A.T.A. request will be reviewed by a committee that will advise the relevant tax inspector. Submission of a request is subject to a fee of up to €10,000, payable to the Luxembourg tax authorities.

In an advance pricing agreement ("A.P.A."), the arm's length character of the remuneration to be earned by a Luxembourg company on its intra-group financing activities is confirmed. The financing company must meet certain conditions to be able to obtain an A.P.A. These conditions are set out in a regulation issued by the Luxembourg tax authorities on December 27, 2016 (the "Circular"). Such conditions include, amongst others, the qualification and functions of relevant employees, the countries affected by the financing transactions, information on the parties involved in the controlled transaction, and a detailed transfer pricing analysis. Following the introduction of the Circular, all A.P.A.'s previously obtained and other individual administrative decisions "in relation to the arm's length principle" are no longer binding on the Luxembourg tax authorities as of January 1, 2017 for tax years beginning after 2016. Whereas the Circular addresses intra-group financing companies, the above statement is worded without restriction in scope. It is therefore unclear whether it targets more than just transfer pricing rulings obtained by intra-group financing companies.

"All A.P.A.'s previously obtained and other individual administrative decisions 'in relation to the arm's length principle' are no longer binding on the Luxembourg tax authorities as of January 1, 2017 for tax years beginning after 2016."

During 2016, the European Commission has continued its examination of the A.T.A. and A.P.A. practices of various E.U. Member States, including Luxembourg, in light of potential unlawful State Aid. The European Commission has repeatedly stated that an A.T.A./A.P.A. that merely confirms in advance the application of tax law in a particular case is legitimate. On the other hand, an A.T.A./A.P.A. that grants State Aid is not allowed under the E.U. treaties. Under State Aid rules, it is in general unlawful for E.U. Member States to grant, on a selective basis, aid (including tax benefits) to undertakings. If unlawful aid was granted, the European Commission can order the Member State involved to recover that aid from the beneficiary undertaking, with interest.

Regarding Luxembourg, the European Commission is investigating or has investigated A.T.A.'s issued to GDF Suez, Amazon, McDonald's, and Fiat Finance and Trade ("F.F.T.") in light of possible State Aid aspects. Preliminary findings were published on October 17, 2014 regarding F.F.T., on February 6, 2015 regarding Amazon, on June 6, 2016 regarding McDonald's, and on January 5, 2017 regarding GDF Suez.

On June 9, 2016, the European Commission's negative decision with regard to the F.F.T. case was published, stating that the European Commission has decided that Luxembourg granted selective tax advantages to F.F.T. The European Commission ordered Luxembourg to recover the unpaid tax from F.F.T. in order to remove the unfair competitive advantage they enjoyed and to restore equal treatment with other companies in similar situations. In addition, F.F.T. can no longer continue to benefit from the advantageous tax treatment granted by these tax rulings. Luxembourg and F.F.T. have lodged an appeal against the E.U. Commission's decision with the European General Court (cases T-755/15 and T-759/15, respectively).

Following the "Lux Leaks" events in November and December of 2014, a substantial number of rulings approved by the Luxembourg tax authorities in the years 2002 to

2010 were leaked to the International Consortium of Investigative Journalists. The Director General of Competition has stated that the European Commission considers the leaked documents to be market information and that it will examine the documents and evaluate whether they will lead to the opening of new cases.[3] In the abovementioned press release on the F.F.T. case, the E.U. Commission also stated that it continues to pursue its inquiry into tax rulings practices in all E.U. Member States and cannot prejudge the opening of additional formal investigations.

S.I.C.A.R.

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

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

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

A S.I.C.A.R. organized as a limited partnership is not subject to C.I.T. due to its tax transparency. As a result, its profits will not be liable to Luxembourg income taxes (whether at fund or investor level), nor will its distributions give rise to any withholding tax.

R.A.I.F.

The R.A.I.F. is an attractive new regime created in July 2016. It allows for flexible establishment and operating rules: its setup does not require approval by the C.S.S.F., and it is also allowed certain structuring features which at present are only available to regulated A.I.F.'s (*e.g.*, umbrella structure, variable capital, specific tax regime). In addition, access to the marketing passport as per Directive 2011/61/E.U. on A.I.F. managers (the "A.I.F.M.D.") is available, and investors' protection is ensured by the full application of the A.I.F.M.D. regime at the manager's level.

---

3 Jacobsen, Henriette. "Vestager Says Will Use 'Luxleaks' Documents in EU Tax Probe." EurActiv. November 20, 2014.

R.A.I.F.'s are by default only subject at the fund entity level to an annual subscription tax levied at a rate of 0.01% of its net assets. Irrespective of the legal form chosen for an R.A.I.F., it will not be subject to C.I.T., municipal business tax, or net wealth tax, and distributions of profits by an R.A.I.F. will not give rise to a withholding tax.

As an alternative to the default tax regime, an R.A.I.F. may choose to be taxed according to the same tax rules as those applicable to S.I.C.A.R.'s (as described above in **S.I.C.A.R.**).

SECURITIZATION VEHICLES

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

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

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

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

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

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

Securitization vehicles are, in principle, fully subject to Luxembourg corporation income tax at the standard combined rate of 27.08%. However, the securitization vehicle is able to deduct from its taxable base all "commitments" owed to investors and creditors. A commitment should be interpreted as including all payments, either in the form of interest or dividend, made by the securitization vehicle to its investors and creditors. The taxable result of the company could, therefore, be virtually reduced to nil, albeit that a securitization vehicle is subject to the minimum tax described in Paragraph A. Securitization vehicles set up in the form of a fund are considered transparent for corporation income tax purposes.

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

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

Securitization vehicles are exempt from net worth tax.

RECENT AND CURRENT DEVELOPMENTS

Transfer Pricing Regulation

To strengthen the transparency of Luxembourg transfer pricing legislation, the arm's length principle has been codified in Article 56 of the I.T.A. as of January 1, 2015 and Article 56bis of the I.T.A. as of January 1, 2017. The wording of Article 56 of the I.T.A. is inspired by Article 9 of the O.E.C.D. Model Tax Convention. The legislation stipulates that upon the request of the tax authorities, the taxpayer is obliged to present relevant information underlying the transfer prices agreed upon between associated enterprises. Based on the literal wording of Article 56, Luxembourg companies should be allowed to deduct a deemed interest expense on interest-free debt for corporation income tax and municipal business tax purposes. As there may be some doubt in this respect, an A.T.A may be sought from the Luxembourg tax authorities to obtain certainty.

The new Article 56bis of the I.T.A. lays down the basic principles for a transfer pricing analysis. These principles are in line with the O.E.C.D. transfer pricing guidelines and Action Items 8 through 10 of the B.E.P.S. Action Plan.

On December 27, 2016, the Luxembourg tax authorities published the Circular to Articles 56 and 56bis of the I.T.A., reshaping the rules for Luxembourg companies engaged in intra-group financing activities. The purpose of the Circular is to clarify the Luxembourg tax authorities' interpretation of the abovementioned provisions in regard to intra-group financing activities. According to the Circular, intra-group financing activities comprise all interest-bearing lending to related companies that are funded with financial instruments in- or outside the group.

The guiding principles of the Circular are that intra-group financing companies must have the financial capacity to assume risks and the ability to control and manage such risks. With respect to the financial capacity, the previous circular generally considered a minimum amount of equity at risk equal to the lower of either 1% of the intra-group financing amount or €2 million to be adequate. The Circular, however, states that the appropriate amount of equity at risk should be determined on a case-by-case basis. On the control and management of risk, the Circular refers to adequate people functions. The specific substance requirements are broadly similar to those outlined in the previous circular:

- Key decisions are made in Luxembourg
- Qualified personnel are adapted to the needs of the control of the transactions being carried out
- A majority of board members are Luxembourg residents
- At least one annual shareholder meeting is held in Luxembourg
- The company is not tax resident in another jurisdiction

In addition, the Circular requires that personnel should have an understanding of risk management in relation to the being transactions carried out.

The Circular also provides for safe harbors in certain circumstances:

- An after-tax return on equity of 10% may reflect an arm's length compensation for financing and treasury functions for companies with a functional profile similar to that of a regulated financial undertaking. This percentage will be regularly reviewed and updated by the Luxembourg direct tax authorities.
- For intra-group financing companies performing pure intermediary activities, transactions will be considered to respect the arm's length principle if a minimum after-tax return of 2% on the amount of the financing activity is reported. Intra-group financing companies will have the option to deviate from this simplification measure based on a transfer pricing report. The Circular, however, does not define pure intermediary activities.

Finally, the Circular states that all rulings and other individual administrative decisions "in relation to the arm's length principle" will no longer be binding on the Luxembourg tax authorities as of January 1, 2017 for tax years beginning after 2016. Whereas the Circular addresses intra-group financing companies, the above statement is worded without restriction in scope. It is therefore unclear whether it targets more than just transfer pricing rulings obtained by intra-group financing companies.

Taxpayers wishing to have certainty on transfer pricing continue to have the option to file an A.P.A. with the Luxembourg direct tax authorities. See **Advance Tax Agreements and Advance Pricing Agreements** above.

Developments in Exchange of Information

Luxembourg and the United States concluded a Model 1 intergovernmental agreement ("I.G.A.") regarding the application of F.A.T.C.A. in Luxembourg on March 28, 2014. The I.G.A. was implemented in Luxembourg domestic law by a law dated July 24, 2015. Reporting Luxembourg financial institutions must give specified information on their U.S. account holders to the Luxembourg tax authorities, which in turn will pass that information to the U.S. Internal Revenue Service. The first year for which information was required to be exchanged was 2014. On July 31, 2015, the Luxembourg tax authorities published guidance notes on the I.G.A. regarding the intergovernmental implementation of F.A.T.C.A. The notes clarify some definitions and procedures to be followed by companies considered Luxembourg financial institutions under the I.G.A.

“The law has introduced a secondary reporting mechanism whereby the reporting obligations are, under certain conditions, shifted from the parent company to a Luxembourg subsidiary or a permanent establishment.”

Luxembourg has also implemented the O.E.C.D.’s common reporting standard (“C.R.S.”) and the revised E.U. directive on administrative cooperation (2014/107/E.C.), which effectively implements the C.R.S. into E.U. law. Luxembourg financial institutions therefore must comply with additional due diligence rules for their account holders and the shareholders of investment entities. Further, additional reporting rules apply for Luxembourg financial institutions with financial accounts held by persons who are tax resident in an E.U. Member State or a country participating in the C.R.S. The first year for which information must be exchanged is 2016 and the first report is due by June 30, 2017.

Finally, on December 8, 2015, the E.U. Council adopted Directive 2015/2376/E.U. (the “E.O.I. Directive”) amending Directive 2011/16/E.U. regarding the mandatory automatic exchange of information in the field of taxation. The E.O.I. Directive has introduced, as of January 1, 2017, the mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements and is aimed at enhancing fiscal transparency between E.U. Member States and deterring aggressive tax planning and abusive tax practices. The automatic exchange should include a defined set of basic information that will be sent to all Member States and the E.U. Commission (though the latter’s access is limited). After the exchange of information takes place, an E.U. Member State may request additional information if it believes the information is relevant to the application of its own tax rules. The information is covered by Form 777E, which serves to summarize the content, scope, and application of the A.T.A./A.P.A.

The automatic exchange covers A.T.A.’s/A.P.A.’s (i) issued, amended, or renewed after December 31, 2016, and (ii) issued less than five years prior. Only rulings involving cross-border transactions are covered by the E.O.I. Directive, and rulings concerning only natural persons are excluded.

Rulings and pricing arrangements issued after December 31, 2016 will need to be communicated within three months following the end of the calendar-year semester in which they are issued. Rulings and advance pricing arrangements issued between January 1, 2012 and December 31, 2013 which are still valid on January 1, 2014, and rulings and advance pricing arrangements issued between January 1, 2014 and December 31, 2016 (whether still valid or not) will be reported before January 1, 2018. Rulings and advance pricing arrangements issued before April 1, 2016 concerning persons with a group-wide annual net turnover exceeding €40 million do not need to be reported.

Country-by-Country Reporting

On December 13, 2016, the Luxembourg Parliament adopted a law on Country-by-Country Reporting, in accordance with E.U. Directive 2016/881 of May 25, 2016 requiring the implementation of a CbC Reporting obligation in Member States’ national legislation. The obligation to prepare a CbC Report applies to large multinational enterprise groups whose total consolidated group revenue exceeds €750 million during the previous fiscal year. Each Luxembourg tax resident entity that is the parent entity of a multinational group, or any other reporting entity defined in the draft law, should file a CbC Report with the Luxembourg tax authorities. In addition, the law has introduced a secondary reporting mechanism whereby the reporting obligations are, under certain conditions, shifted from the parent company to a Luxembourg subsidiary or a permanent establishment. The CbC Report must be filed for fiscal years starting on or after January 1, 2016. The deadline for the submission of CbC Reports is 12 months after the last day of the relevant fiscal year. In addition, each Luxembourg entity that is part of a multinational enterprise group must notify the Luxembourg tax authorities on an annual basis of the identity of the entity that will be filing the CbC Report for the year concerned. The deadline for this notification is the last day of the fiscal year of the multinational enterprise group.

U.B.O. Register

Luxembourg has not yet drafted a bill of law with regard to the implementation in its national law of E.U. Directive 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (the "A.M.L.D."). The A.M.L.D. also introduces a publicly-accessible register of ultimate beneficial owners, *i.e.*, the "U.B.O. Register." The A.M.L.D. must be transposed into national law before June 26, 2017, and as of the date of this publication, a bill of law is expected at any time.

SWITZERLAND

Author
Stephan Neidhardt
Walder Wyss Ltd.
Zürich, Switzerland

IN GENERAL

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

The Federal corporation income tax rate for ordinarily taxed companies is 8.5%, but because taxes are deductible, the effective Federal income tax rate is 7.8%. The cantonal and communal corporation income tax rates depend on the company's location. The combined effective ordinary income tax rates (which include Federal, cantonal, and communal taxes) vary among the cantons. The combined rates of tax are as follows: 12.32% in Lucerne; 13.04% in Appenzell and Ausserrhoden; 12.74% in Obwalden; 12.66% in Nidwalden; 14.60% in Zug; 21.15% in Zürich; and 24.16% in Geneva.

In addition to corporation income tax, capital taxes are imposed on the cantonal and communal levels. No capital tax is imposed at the Federal level. On the cantonal and communal levels, holding companies pay a reduced capital tax in the range of one per thousandth (capital x 0.001) to 0.25%. The respective tax rates have been reduced dramatically in recent years, and in some cantons, the possibility exists to credit corporation income taxes against the capital tax.

TAXATION OF HOLDING COMPANIES

Corporation Income Tax

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

---

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

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

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

Capital Tax[3]

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

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

Stamp Duty[4]

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

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

---

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

3 Reductions in capital tax are within the scope of Swiss Corporate Tax Reform 2017. For possible consequences, see **Future Taxation of Swiss Holding Companies**, below.

4 Stamp duty is no longer within the scope of Swiss Corporate Tax Reform 2017. For possible consequences, see **Future Taxation of Swiss Holding Companies**, below.

of a participation of at least 10% to another company would also qualify as a tax neutral restructuring and, thus, benefit from the stamp duty exemption.

Value Added Tax

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

"A notification procedure allows for full relief from withholding tax, provided that the Swiss tax authorities are notified in advance of the payment and grant permission for such relief."

Securities Transfer Tax

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

Swiss Withholding Tax

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

Under certain circumstances, a notification procedure allows for full relief from withholding tax, provided that the Swiss tax authorities are notified in advance of the payment and grant permission for such relief. The notification procedure applies to dividend distributions from a Swiss subsidiary to a Swiss parent company, provided that the beneficiary owns at least a 10% interest in its Swiss subsidiary.

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

If the parent company is based in the U.S. or certain other countries, dividend distributions are subject to a reduced Swiss withholding tax (*e.g.*, 5% for the U.S.). The notification procedure should be available if the requirements of the relevant double tax treaty are met (*e.g.*, for the U.S., the parent company must hold at least 10% of all voting rights) and permission for partial relief at the source has been obtained prior to any dividend distribution.

Tax Credit for Foreign Withholding Taxes

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

Swiss Tax Treaty Network

Switzerland has income tax treaties with 109 jurisdictions, including all old and new E.U. countries and the majority of Switzerland's important trading partners. It has also entered into several limited treaties regarding sea and air enterprises.

Albania	Algeria	Anguilla	Antigua & Barbuda
Argentina	Armenia	Australia	Austria
Azerbaijan	Bangladesh	Barbados	Belarus
Belgium	Belize	British Virgin Islands	Bulgaria
Canada	Chile	China	Colombia
Croatia	Cyprus	Czech Republic	Denmark
Dominica	Ecuador	Egypt	Estonia
Faroe Islands	Finland	France	Gambia
Georgia	Germany	Ghana	Greece
Grenada	Hong Kong	Hungary	Iceland
India	Indonesia	Iran	Ireland
Israel	Italy	Ivory Coast	Jamaica
Japan	Kazakhstan	Kuwait	Kyrgyzstan
Latvia	Liechtenstein	Lithuania	Luxembourg
Macedonia	Malawi	Malaysia	Malta
Mexico	Moldova	Mongolia	Montenegro
Montserrat	Morocco	Netherlands	New Zealand
Norway	Oman	Pakistan	Peru
Philippines	Poland	Portugal	Qatar
Romania	Russia	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sri Lanka	St. Kitts & Nevis	St. Lucia
St. Vincent & the Grenadines	Sweden	Taiwan	Tajikistan
Thailand	Trinidad & Tobago	Tunisia	Turkey
Turkmenistan	Ukraine	United Arab Emirates	United Kingdom
United States	Uruguay	Uzbekistan	Venezuela
Vietnam	Zambia		

1962 Anti-Abuse Decree

Since 1962, Swiss internal law has contained measures designed to prevent the misuse of double tax treaties. The original legislation, herein referred to as the "1962 Decree," was revised at the end of 1998 and again during 2010.

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

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

1999 Circular Letter

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

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

2010 Circular Letter

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

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

Neither the 1962 Decree nor the Circular Letters of 1962, 1999, and 2010 are applicable in the context of a company having contacts with the U.S. The Switzerland-U.S. Income Tax Treaty of 1996 overrules the application of the Swiss legislation with its extensive limitation on benefits provisions. Consequently, Swiss companies investing in the U.S. must look exclusively to the tax treaty in order to determine whether misuse exists.

Holding Company Activities

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

- Financing subsidiaries and other group companies
- Holding and managing intellectual property
- Performing management services within the group

> ***"A Swiss holding company may be attractive because its functions are not strictly limited to holding activities."***

Consequently, a Swiss holding company can employ personnel and it may rent office space. In light of recent initiatives focused on combatting base erosion and profit shifting and other ongoing changes in worldwide taxation principles, it is advisable for a holding company to have substance in Switzerland in the form of office space that is actively used by competent personnel. Due to cantonal and communal level tax exemptions, income derived from the foregoing activities (*i.e.*, interest, royalty, and management income) is taxable on the Federal level, only (where the effective tax rate is 7.8%). Nonetheless, because Swiss law does not contain a bright-line test, it is customary to obtain a ruling from the tax authorities with regard to the substantial performance of functions other than holding company functions. However, if the ruling affects a member of the E.U., the ruling may need to be circulated to the tax authorities in the affected country.

It should be noted that the tax exemption for certain holding company activities will most likely cease on December 31, 2018 (see **Future Taxation of Swiss Holding Companies** below).

Multilateral Instrument

Switzerland has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. The Federal government announced that it will implement the minimum standards either within the framework of the Multilateral Convention or by means of the bilateral negotiation of double taxation agreements.

Initially, the Swiss income tax treaties with Argentina, Chile, India, Iceland, Italy, Liechtenstein, Lithuania, Luxembourg, Austria, Poland, Portugal, South Africa, the Czech Republic, and Turkey will be amended by the Multilateral Instrument. These partner states are prepared to come to an agreement with Switzerland on the precise wording of the necessary amendments to the provisions of the existing income tax treaties. If agreements on the technical implementation of the Multilateral Instrument can be obtained with further partner states, the corresponding income tax treaties will equally be amended by the Multilateral Instrument at a later stage. Alternatively, the B.E.P.S. minimum standards can also be implemented by means of a bilateral income tax treaty amendment.

Materially, the new treaty provisions resulting from the B.E.P.S. minimum standards modify the description of purpose in the preamble, include a standard anti-abuse clause, and adjust the provisions governing dispute resolution within the framework of mutual agreement procedures. In keeping with its treaty policy, Switzerland opts for the inclusion of the mandatory and binding arbitration clause provided for in the Multilateral Instrument.

The Federal Council will submit the Multilateral Instrument for public consultation towards the end of 2017. It will undergo the standard parliamentary approval process before entering into force.

ADDITIONAL TAX-RELATED ISSUES

U.S. Check-the-Box Rules

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

Swiss Ruling Policy

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

All cases that do not clearly align with the tax codes or that are not based on a well-known government practice will generally be the subject of an advance ruling request by a taxpayer. Again, Swiss rulings that have an effect in a member jurisdiction of the E.U. may be reported to the tax authorities in that jurisdiction.

Swiss Debt-Equity Rules

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

Note, however, that a 2015 court decision approved the interest deductibility of higher amounts, if the taxpayer can prove that such payments meet the arm's length standard. To illustrate, the book value of real estate is typically reduced over time to reflect depreciation. Nonetheless, its fair market value may increase substantially and unrelated lenders will typically compute leverage capacity based on the fair market value rather than the book value of the real estate.

Use of Swiss Holding Companies

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

- An activity clause is not required for investments (*i.e.*, participations owned by a Swiss holding company can also be qualified as portfolio investments).
- A "subject-to-tax clause" does not exist for underlying participations.
- In connection with dividend distributions, there is no holding period requirement for investments.
- There is no capital gains tax on the sale of participations of 10% or more once a one-year holding period exists for the participation.
- Income that is not dividend income is subject to Federal income tax only, imposed at an effective tax rate of 7.8%. This should be compared to the tax rates in effect in E.U. Member States, which tend to range between 20% and 40%.[5]
- Switzerland does not levy withholding tax on outbound royalties and outbound interest payments, with the exception of interest paid on bonds.
- Switzerland does not have any C.F.C. legislation.

"On June 1, 2017, a steering committee representing the cantons and the Swiss Federation issued recommendations for a modified corporate tax reform package."

Future Taxation of Swiss Holding Companies

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

On June 14, 2016, the Swiss Parliament approved a new law known as Corporate Tax Reform III. The new law was voted down by the Swiss people on February 12, 2017. Slated to take effect in 2019, the new law would have introduced the following measures, designed to be compatible with the latest international standards:

- Beginning after 2018, the tax-free treatment of interest and other income would have ceased with the abolition of domiciliary and mixed companies and changes to the holding company regime. However, for private holding companies with only dividend income, the new law would not have led to higher taxes. Eventually, taxes might even have been lower due to the new notional interest deduction ("N.I.D."), as described below.
- When a foreign company would have been domesticated into Switzerland or a change would have occurred in a Swiss company's tax status (*e.g.*, the termination of a special tax status, such as holding company status), a tax-free step up to fair market value would have been allowed with regard to the basis of the assets reported on the company's tax balance sheet. This would have resulted in an increase in the allowance for depreciation for Federal and cantonal tax purposes in Switzerland.
- A Patent Box company regime would have been introduced at the cantonal tax level (and not on the Federal level), providing for privileged taxation of income from patents and similar intellectual property rights. The tax exemption could have reached up to 90% of qualifying I.P. income. The O.E.C.D.'s nexus approach for I.P. regimes would have been applied, *i.e.*, the R&D

[5] This policy is likely to cease on December 31, 2018.

expenses would have to have been incurred through operations carried on by the Patent Box company itself.

- A super-deduction of up to 150% for Swiss R&D expenses would have been introduced at the cantonal tax level. Each canton would have been free to choose whether to enact these new R&D tax incentives.

- The N.I.D. would have been introduced on the Federal level. Cantons would have been allowed to decide whether to introduce the N.I.D. on the cantonal level. This provision would have favored companies that are highly financed with equity, as a notional interest expense deduction would have been generated by equity. If a canton had chosen to introduce the N.I.D., it would have been forced to implement a minimum taxable income inclusion of 60% for dividends received by Swiss residents from shareholdings of at least 10%. In this way, the deduction at the level of the operating company would have to be clawed back in part at the level of its shareholders owning 10% or more of the equity.

- In addition to the above, the cantons would have been free to reduce both the corporate income and capital tax rates.

Three previous proposals have been withdrawn from the Corporate Tax Reform III:

- The abolition of the Federal stamp tax on equity

- The introduction of a so-called "tonnage tax" for ships registered in Switzerland

- The introduction of a general capital gains tax for individuals

On June 1, 2017, a steering committee representing the cantons and the Swiss Federation issued recommendations for a modified corporate tax reform package. The corporate tax reform legislation, known as "T.P. 17," is based on Corporate Tax Reform III and contains a social component for individuals that is intended to achieve a political compromise. Among other things, T.P. 17

- excludes the N.I.D.,

- includes a modified Patent Box regime, but without benefits to software companies, and

- provides an overall limitation of tax reduction at the cantonal level to 70%.

The outcome is not yet clear. The Swiss Parliament's aim is to negotiate certain compromises in order to avoid another public vote. Without a public vote, the new law could come into force as of January 1, 2019. Should there be a public vote, a delay of one year, to 2020, is possible. It is therefore unknown whether the new law will come into effect as planned in 2019.

THE NETHERLANDS

Author
Ewout van Asbeck
Van Doorne
Amsterdam, Netherlands

Over the past few decades, the Netherlands has been a prime location for holding companies. The Netherlands was deemed to be so attractive that a number of countries have copied the Dutch participation exemption system with more or less success. 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 foregoing benefits are supplemented by bilateral investment treaties that provide protection for investments of Dutch-resident entities when jurisdictions enact measures targeting foreign investors. The benefits of an extensive treaty network have been enhanced in the last few years with the popularity of the legal form of the so-called Cooperative ("*Coöperatie*") as a holding vehicle, allowing international holding structures to distribute profits free from Dutch dividend withholding tax. The latter, however, is subject to change, as the Ministry of Finance has launched a public (Internet) consultation on a legislative proposal that would introduce a dividend withholding tax obligation for Cooperatives used as a holding vehicle (see **Dividend Withholding Tax** below).

CORPORATION INCOME TAX – GENERAL

In principle, all income of a holding company will be subject to Dutch corporation income tax at the rate of 25% for profits exceeding €200,000. Profits up to €200,000 are taxed at a rate of 20%. As part of the 2017 Tax Plan, the first bracket will be extended to €250,000 in 2018, €300,000 in 2020, and €350,000 in 2021. However, because of the Dutch participation exemption, a Dutch-resident holding company will often have little or no taxable income.

PARTICIPATION EXEMPTION

In General

Under the participation exemption set forth in Article 13 of the Corporation Income Tax Act ("C.I.T.A."), dividends (including dividends in kind and "hidden" profit distributions) and capital gains derived from qualifying shareholdings are exempt from Dutch corporation income tax, while capital losses are deductible only under special circumstances (see **Capital Losses** below). No minimum holding period is required, although in a short term buy-and-sell transaction, part of the tax exempt capital gains 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 one of the following criteria is met:

- The Dutch taxpayer holds at least 5% of the nominal paid-up capital of a company with capital divided into shares.
- The Dutch taxpayer holds an interest in an "open" limited partnership that gives entitlement to at least 5% of the profits realized by the open limited partnership.
- The Dutch taxpayer holds at least 5% of the participating certificates of a fund for joint account.
- The Dutch taxpayer is a member of a Cooperative.
- The Dutch taxpayer holds at least 5% of the voting rights in a company that is resident in an E.U. Member State with which the Netherlands has concluded a tax treaty that provides for a reduction of Netherlands dividend withholding tax based on voting rights.

"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."

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

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

Motive Test

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

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

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

Subject-to-Tax Test

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

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

Asset Test

The Asset Test stipulates that the taxpayer must demonstrate that the assets of the participation usually do not consist, directly or indirectly, of more than 50% low-taxed, free passive assets. For this purpose, the assets must be considered at fair market value. The term "usually" implies that the participation exemption remains applicable if the assets of the participation consist of more than 50% of low-taxed, free passive assets for a short period of time only. An example would be where a subsidiary sold its business and holds investment-grade securities until a new business is acquired.

Assets qualify as free passive assets in the following circumstances:

- The assets are passive assets that are not necessary for the business activities of the holder. Interest-bearing bank accounts, loan receivables, and passive investments such as bonds and shares, could 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 zero-taxed investment institution.
- The assets are 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.
- The assets are leased to a group company, unless they are used by an active group leasing company or are financed entirely or almost entirely (90% or more) by third-party debt.

As mentioned above, both directly and indirectly held assets of the participation must be taken into account. Consequently, assets of companies in which the participation holds an interest of at least 5% must be allocated *pro rata* 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 qualify as “bad assets” only if they are considered to be low-taxed. This is generally the case if the income derived from these assets is not subject to a realistic levy according to Dutch tax standards. A similar approach to the Subject-to-Tax Test applies for this purpose.

Earn-Out and Balance Guarantee Arrangements

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

Expiring Participation

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

Non-Qualifying Participations

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

Stock Options and Convertible Bonds

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

Hybrid Loans and Profit Rights

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

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

If a loan qualifies as a hybrid loan, the loan will be regarded as capital for corporation income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporation income tax purposes and, in principle, will be subject to a 15% dividend withholding tax.[1] On the other hand, the interest and principal paid on a hybrid loan will be exempt from Dutch corporation 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 if the borrower qualifies as a related entity of the lender. See **In General**, above.

The Anti-Tax Avoidance Directive within the E.U. restricts the benefits of the Parent-Subsidiary Directive ("P.S.D.") where the participation exemption results in double nontaxation. The participation exemption is not applicable to payments or other forms of remuneration derived from a participation to the extent these payments can be deducted legally or *de facto*, directly or indirectly, from the basis on which taxable profit is calculated. This may be the case for certain hybrid financial instruments, typically including hybrid loan receivables on participations held by Dutch parent companies. The anti-hybrid-instrument legislation has worldwide applicability (*i.e.*, it is not restricted to E.U. subsidiaries). Moreover, it is not limited to hybrid loans (*e.g.*, deductible dividend instruments, such as preferred shares, may be covered) and also applies to income received in lieu of payments covered by the legislation.

Partitioning Reserve

If a taxpayer holds an interest in a company that undergoes a change in treatment (a "transition") regarding application of the participation exemption, the taxpayer should form a so-called partitioning reserve with regard to the shares held. The purpose of this reserve is to determine the taxable or exempt amount of gains or losses, in order to avoid double taxation upon a realization of a gain or loss originating in the period prior to the formation of the partitioning reserve.

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

OTHER ASPECTS

Costs and Expenses

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

Base Erosion

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

[1] For further explanation regarding dividend withholding tax, see **Dividend Withholding Tax** below.

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

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

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

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

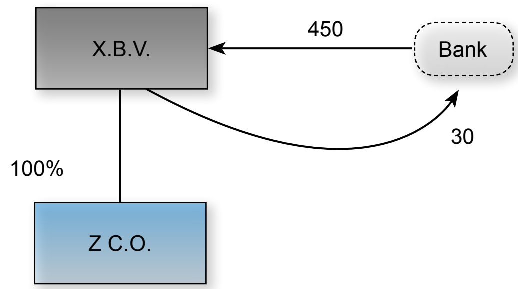
- The taxpayer holds at least one-third of the capital in the other entity.
- The other entity holds at least one-third of the capital of the taxpayer.
- A third party holds at least one-third of the capital in both entities.
- The taxpayer and the other entity are part of the same fiscal unit for Dutch corporation income tax purposes.
- The taxpayer is part of a cooperating group of companies holding a total combined interest of at least one-third of the capital in the other entity.

Excessive Debt Financing for Holding Companies

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

The limitation can be explained through the following example:

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



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

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

- Application of Article 13L of the 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 corporation income tax purposes. In order to calculate the total amount of nondeductible interest, the participation debt (€150 million) must be divided by the total amount of debt (€450 million), the result of which should be multiplied by the actual interest expense (*i.e.*, 150/450 x 30 = €10 million). After taking the €750,000 threshold into account, a total amount of €9.25 million is characterized as nondeductible interest paid in relation to the acquisition of the participation. Consequently, in this example, the interest is deductible up to €20.75 million. The result is a taxable profit of €4.25 million (€25 million - €20.75 million) instead of a tax loss of €5 million, which would be realized without the application of article 13L of the C.I.T.A.

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

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

Dutch Acquisition Holding Company

Deductibility of interest expense is also limited for a Dutch acquisition holding company in connection with a loan taken up to acquire a Dutch target company that

would be included with the acquiring entity in a fiscal unit for Dutch corporation income tax purposes post-acquisition. The benefit of establishing a fiscal unity structure is that the interest paid by the acquisition vehicle would be deductible from the profits of the target company. By forming a fiscal unity, the acquisition holding company would be deemed to absorb all assets and liabilities of the target company including its profits. Under Article 15ad of the C.I.T.A., interest paid by the Dutch acquisition holding company will only be deductible from the profits of that acquisition company, which generally would be negligible. The limitation applies only to the extent that the interest expense exceeds €1 million per year and the acquisition loan exceeds 60% of the acquisition price of the shares in the year of acquisition. In the following seven years, the loan should be repaid at a rate of 5% of the original principal per year, ultimately leaving an outstanding loan equal to 25% of the acquisition price. The nondeductible interest expense can be carried forward. Article 15ad of the C.I.T.A. is applicable to both group loans and third-party loans. It also applies to post-acquisition legal mergers and liquidations within a fiscal unit. Until January 1, 2017, the adverse consequences of Article 15ad of the C.I.T.A. could largely be avoided through the use of debt push-downs. The 2017 Tax Bill has closed this and other loopholes in Article 15ad of the C.I.T.A. As of January 1, 2017, the mathematical rule for cases in which an acquisition debt by means of a "debt push-down" is moved from the level of the acquiring company to the level of the acquired company is amended. In addition, the 2017 Tax Bill prevents intra-group transactions that could result in resetting the phase-out period of seven years back to 60% of the acquisition price of the shares. The phase-out period now continues to apply if the acquired company is transferred to another group company.

Innovation Box

In order to stimulate research and development activities by Dutch taxpayers, self-developed registered patents and certain other assets for which a so-called research and development statement has been requested, apart from expensing costs related to R&D activities in the year incurred, (collectively, "R&D Assets") may be placed in a so-called Innovation Box. Pursuant to the Innovation Box regime, a 5% effective tax rate applies to income generated by a qualifying intangible, to the extent the income from the intangible exceeds the related R&D expenses, other charges, and amortization of the intangible. Income includes royalty income such as license fees and other income stemming from R&D Assets. The taxpayer should be the registered and beneficial owner of the patents and the beneficial owner of the other assets for which a so-called R&D statement has been requested. Trademarks are specifically excluded from this beneficial regime. This 5% effective tax rate will apply only to qualifying income. The non-qualifying income will continue to be subject to tax at the statutory rates of 20% and 25%.

The Innovation Box regime applies to income received from related and unrelated parties. The facility contains a threshold to prevent taxpayers from deducting expenses at the statutory rate while the corresponding earnings are taxed at the reduced effective rate of 5%. For this reason, the qualifying earnings should exceed the threshold before the effective tax rate of 5% can apply. The threshold is formed by the development costs of the intangible asset earmarked for the Innovation Box. The decision to use the Innovation Box should be made when the corporation income tax return is filed.

Following the outcome of the O.E.C.D.'s efforts to combat base erosion and profit shifting (the "B.E.P.S. Project"), minimum requirements for the application of so-called preferential I.P. regimes, such as the Dutch Innovation Box regime, have been established by the O.E.C.D. All E.U. Member States have committed themselves to adapt their preferential I.P. regimes to comply with these new minimum requirements. Consequently, the Dutch Innovation Box regime has been amended, resulting in the following five main changes:

- A so-called "nexus approach" has been introduced to determine income that is attributable to the innovation and eligible for the reduced rate.
- To be eligible for the reduced rate, all technical innovations must be developed as part of an "approved project," which is an R&D project that qualifies for the Dutch R&D subsidy (also known as "W.B.S.O.").
- For larger companies, *i.e.*, companies with a global group-wide turnover of at least €50 million annually or income generated by technical innovations of at least €7.5 million per year, technical innovations must (i) be protected by a patent or plant breeders' rights,[2] or (ii) qualify as software.
- More extensive documentation and administrative requirements have been introduced.
- Grandfathering rules will apply up to 2021 for innovations that were produced before June 30, 2016 and that were already benefitting from the Innovation Box at that time.

"A 5% effective tax rate applies to income generated by a qualifying intangible. . . . Non-qualifying income will continue to be subject to tax at the statutory rates of 20% and 25%."

These adjustments became effective as of January 1, 2017. However, it should be noted that the new minimum requirements apply to new technical innovations that were produced on or after July 1, 2016.

Capital Losses

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

Tax Treaty Network

The Netherlands has a robust tax treaty network with more than 90 countries. The jurisdictions with which the Netherlands has a tax treaty currently in force as of May 1, 2017 are listed in the table below.

Albania	Argentina	Armenia	Aruba
Australia	Austria	Azerbaijan	B.E.S. Islands
Bahrain	Bangladesh	Barbados	Belarus
Belgium	Bermuda	Bosnia & Herzegovina	Brazil
Bulgaria	Canada	China	Croatia
Curaçao	Czech Republic	Denmark	Egypt

2 Plant breeder's rights are rights granted to the breeder of a new variety of plant that give the breeder exclusive control over the propagating material for the plant.

Estonia	Ethiopia	Finland	France
Georgia	Germany	Ghana	Greece
Hong Kong	Hungary	Iceland	India
Indonesia	Ireland	Israel	Italy
Japan	Jordan	Kazakhstan	Kosovo
Latvia	Lithuania	Luxembourg	Macedonia
Malaysia	Malta	Mexico	Moldova
Montenegro	Morocco	New Zealand	Nigeria
Norway	Oman	Pakistan	Panama
Philippines	Poland	Portugal	Qatar
Romania	Russia	Saudi Arabia	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Spain	Sri Lanka	St. Martin
Suriname	Sweden	Switzerland	Taiwan
Tajikistan	Thailand	Tunisia	Turkey
Uganda	Ukraine	United Arab Emirates	United Kingdom
United States	Uzbekistan	Venezuela	Vietnam
Zambia	Zimbabwe		

The Netherlands has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

TAX RULINGS

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

- At least half of the managing directors reside or are established in the Netherlands.
- The company's Dutch-resident managing director(s) have sufficient professional knowledge to perform their duties.
- The company has personnel qualified for the proper execution and registration of the planned transaction.
- All management board meetings are held in the Netherlands and are in principle attended by all board members.
- All decisions of the management board should be prepared and executed in the Netherlands.
- The bank account(s) of the company are managed and maintained in or from the Netherlands.
- The Dutch-resident managing director(s) should be solely authorized to approve all transactions on the company's main bank account(s).
- The bookkeeping of the company is done in the Netherlands.

- The company's address is in the Netherlands.
- The company is not considered to be resident of another country.
- The company runs real risks with respect to its financing, licensing, or leasing activities.
- The company finances its participations with a minimum of 15% equity.[3]

It is also necessary, in certain situations, for foreign intermediate holding companies, or direct foreign members performing a "linking function," to have "sufficient substance" in their country of residence in order to prevent the application of anti-abuse rules that would effectively nullify the advance tax ruling (see **Dividend Withholding Tax** and **Extra-Territorial Taxation and Anti-Abuse Rules** below, regarding the aforementioned situations).

DIVIDEND WITHHOLDING TAX

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

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

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

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

Dividend withholding tax may be avoided altogether when a Dutch holding company

---

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

is established in the form of a Cooperative because profit distributions by a Cooperative are not subject to dividend withholding tax, unless the anti-abuse rule applies. This anti-abuse rule stipulates that a Cooperative will be treated as an entity with capital divided into shares for Dutch dividend withholding tax purposes. Furthermore, profit distributions made by a Cooperative are subject to 15% Dutch dividend withholding tax if two conditions are met:

- The Cooperative (i) holds direct or indirect shareholdings or profit-sharing certificates or (ii) has granted profit participating loans, with the main purpose, or one of the main purposes, being to avoid the levy of Dutch dividend withholding tax or foreign tax with respect to its direct or indirect members.
- There is an artificial arrangement or a series of artificial arrangements (see **Extra-Territorial Taxation and Anti-Abuse Rules**, below).

In comparison to a corporation, a Cooperative is neither a limited liability company nor a partnership. It is not an entity with capital divided into shares. Consequently, dividend withholding tax is, in principle, not imposed – unless one of the foregoing anti-abuse rules applies. Nonetheless, a Cooperative qualifies as an entity under the P.S.D. and is entitled to an exemption from foreign dividend withholding taxes on incoming dividends of qualifying participations in an E.U. subsidiary.

On May 16, 2017, the Ministry of Finance launched a public (Internet) consultation on a legislative proposal that introduces a dividend withholding tax obligation for Cooperatives used as a holding vehicle. A Cooperative would be deemed to be used as a holding vehicle if at least 70% the activities of the Cooperative consist of holding participations or financing (directly or indirectly) related entities and/or natural persons.

Under the current legislation, a holding vehicle formed as a Cooperative is not subject to dividend withholding tax, whereas entities with capital divided into shares fulfilling a similar function must collect withholding tax. The proposal undergoing the consultation process would introduce measures to eliminate this difference.

In addition, the legislative proposal also outlines measures to broaden the scope of the dividend withholding tax exemption. It is envisaged that no dividend withholding tax would be levied on dividends paid to nonresident corporate shareholders, if the corporate shareholder is a tax resident of a third country (*i.e.*, a country that is not an E.U. Member State) with which the Netherlands has concluded a tax treaty containing a provision covering dividends. The proposed legislation is intended to take effect as of January 1, 2018.

EXTRA-TERRITORIAL TAXATION AND ANTI-ABUSE RULES

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

- The nonresident company holds 5% or more of the shares, or class of shares, of the Dutch holding company (a "Substantial Shareholding"), with a main purpose of, or one of the main purposes being, to avoid the levy of Dutch income tax, dividend withholding tax, or both, with respect to another person.

- There is an artificial arrangement or a series of artificial arrangements.

An arrangement may comprise more than one step. An arrangement or series of arrangements is considered artificial if, and to the extent that, they are not put into place for valid business reasons that reflect economic reality. Valid business reasons maybe present if, *inter alia*, the nonresident company (i) conducts a material business enterprise and the shareholding is part of the business enterprise's assets, (ii) is a top holding company that carries out material management, policy, and financial functions for the group it heads, or (iii) functions as an intermediate holding company within the group structure in relation to the relevant Dutch target.

In the case of an intermediate holding company, as under (iii) above, an additional requirement applies. The holding company must meet the Dutch minimum substance requirements as if it were a resident of the Netherlands (see **Tax Rulings** above). Note that the legislative proposal mentioned in **Dividend Withholding Tax** above also proposes to tighten the Dutch minimum substance requirements as of January 1, 2018.

"The Netherlands does not levy any kind of capital tax, stamp duties, or other registration charges with respect to the issuance or transfer of shares in a Dutch-resident company except for real estate transfer tax."

If the nonresident company holds a Substantial Shareholding only to avoid a Dutch dividend withholding tax, a Substantial Shareholding tax is effectively levied at 15% (on a gross basis) *solely* on dividend income from the Substantial Shareholding.

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

CAPITAL TAX AND STAMP DUTIES

The Netherlands does not levy any kind of capital tax, stamp duties, or other registration charges with respect to the issuance or transfer of shares in a Dutch-resident company except for real estate transfer tax ("R.E.T.T.") in certain circumstances. R.E.T.T. is levied if a purchaser acquires real estate or at least one-third or more of the shares of a "real estate company." A company is considered a real estate company if more than 50% of its assets consist – or consisted one year prior to the acquisition – of real estate used for passive investment and at least 30% of its assets consist of Dutch real estate. R.E.T.T. is levied on the fair market value of real estate located in the Netherlands, with the consideration paid as a minimum. The applicable rate of R.E.T.T. for residential real estate is 2%. In all other cases the applicable rate is 6%.

B.E.P.S.

In an official statement released in September 2014, the Dutch government affirmed that it actively supports the initiatives taken by the G-20 and the O.E.C.D. to battle tax evasion (the "B.E.P.S. Project"). The final reports and recommendations on the 15 B.E.P.S. actions were released by the O.E.C.D. on October 5, 2015. Implementation in the Netherlands is subject to international consensus on the proposed measures.

On January 28, 2016, the European Commission released an anti-tax avoidance ("A.T.A.") package inspired by the B.E.P.S. Project final reports. With the proposed A.T.A. package, the European Commission hopes to ensure that B.E.P.S. Project recommendations are implemented by Member States in accordance with E.U. law and that taxes paid in the Member States correspond to the locations where value is created.

One of the core pillars of the European Commission's agenda was to introduce an Anti-Tax Avoidance Directive, ("A.T.A.D. 1"), also known as the "E.U. B.E.P.S. Directive." A political consensus was reached on June 20, 2016. As a result, the A.T.A.D. 1 contains anti-tax avoidance rules in five specific fields:

- Exit taxation
- Interest deduction limitation;
- Controlled foreign corporation ("C.F.C.") rules
- The general anti-abuse rule ("G.A.A.R.")
- Hybrid mismatches

The main goal of the A.T.A.D. 1 is to provide a minimum level of protection for the internal market and to strengthen the level of protection against aggressive tax planning. The rules are in addition to the changes to the P.S.D. (regarding G.A.A.R. and anti-hybrid financing rules) and may be followed by a relaunched proposal on the Common Corporate Tax Base ("C.C.T.B.") and the Common Consolidated Corporate Tax Base ("C.C.C.T.B.").

On February 21, 2017, the E.U. Member States reached agreement on a directive that will amend the A.T.A.D. 1. This new directive ("A.T.A.D. 2") provides for rules to battle arrangements used by companies that create disparities between two or more tax jurisdictions resulting in an overall reduction of the company's tax liability – so-called "hybrid mismatches."

This newly-adopted directive contains a minimum standard for E.U. Member States and provides for detailed rules to target various hybrid mismatches between Member States and countries outside the E.U. The following mismatches are included:

- Hybrid financial instrument mismatches
- Hybrid entity mismatches
- Reverse hybrid mismatches
- Hybrid transfers
- Hybrid permanent establishment mismatches
- Dual resident mismatches

Member States must implement the A.T.A.D. 2 by December 31, 2019. However, the rules regarding reverse hybrids must be implemented by the Member States in principle by December 31, 2021.

IRELAND

Author
James Somerville
A & L Goodbody
Dublin, Ireland

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

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

The ideal jurisdiction for a holding company would include the following criteria:

- The absence of foreign withholding taxes on the payment of monies to a company located in the jurisdiction
- A low rate of applicable tax
- A developed tax network providing for full credit relief

A low or zero rate of capital gains tax on the disposal of associated companies

- No withholding tax on payments from the jurisdiction
- Reduced foreign tax on dividends received from the jurisdiction

RECENT DEVELOPMENTS

B.E.P.S.

Irish tax policy for attracting jobs through favorable tax rules may be affected by the O.E.C.D.'s base erosion and profit shifting initiative (the "B.E.P.S. Project") and the subsequent B.E.P.S. Action Plan, for which the final reports were published in October 2015. The B.E.P.S. Action Plan identified six key problem areas contributing to the growth of inappropriate profit shifting, including intra-group financial transactions, harmful tax regimes, and digital goods and services.

Ireland has already adopted many of the provisions recommended in the B.E.P.S. Action Plan, including a general anti-avoidance rule ("G.A.A.R."), domestic provisions limiting tax relief on intra-group debt, transfer pricing legislation, and provisions taxing dividends from non-trading foreign subsidiaries at a higher rate of corporate tax than the headline 12.5% rate.

Overall, the Irish government's response has been to welcome the B.E.P.S. Project and the O.E.C.D.'s coordinated effort to deal with the challenges posed by B.E.P.S. The stated position in Ireland is that the B.E.P.S. Project cannot succeed without coordinated multilateral action. While Ireland recognizes that the B.E.P.S. Project involves certain challenges, it also sees new opportunities arising for Ireland and other small countries. This is because the Irish taxation system is built upon substance, and as such, the alignment of profits with substance and a competitive rate of tax accords well with concepts that have been the cornerstone of Ireland's corporate tax policy since the 1950's.

Ireland's reaction to the principal final reports is as follows:

- **Action Item 1 (Digital Economy):** No special action is needed as the O.E.C.D. concluded ring-fenced solutions are not appropriate.
- **Action Item 2 (Hybrid Mismatches), Action Item 3 (C.F.C. Rules), and Action Item 4 (Interest Deductions):** Ireland is not proposing any legislative change at present.
- **Action Item 5 (Harmful Tax Practices):** As a pre-emptive action, Ireland moved to phase out the so-called "double Irish" tax structure in Finance Act 2014 and introduced its own O.E.C.D.-compliant patent tax regime (the "Knowledge Development Box") in Finance Act 2015.
- **Action Item 6 (Treaty Abuse):** Over time, measures to protect against treaty abuse should become part of Ireland's treaties.
- **Actions Items 8, 9, and 10 (Transfer Pricing):** Ireland is expected to adopt the revised O.E.C.D. Guidelines once finalized.
- **Action Item 13 (CbC Reporting):** Ireland signed the O.E.C.D.'s multilateral competent authority agreement in January 2016 and separately introduced Country-by-Country Reporting legislation in Finance Act 2015.
- **Action Item 15 (Multilateral Instrument):** Ireland played its part in the negotiations leading to the adoption of the multi-lateral instrument on November 24-25, 2016. It is a signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

"While, initially, domestic implementation regulations classified relevant holding companies as financial institutions for F.A.T.C.A. purposes, that was found to be inconsistent with the I.G.A. definition of a financial institution."

F.A.T.C.A.

On December 21, 2012, Ireland concluded the Ireland-U.S. intergovernmental agreement in accordance the with the provisions of the U.S. Foreign Account Tax Compliance Act. Implementing legislation was introduced in Finance Act 2013, compelling Irish reporting financial institutions to collect and return certain information to the Irish tax authorities for exchange with the I.R.S.

While, initially, domestic implementation regulations classified relevant holding companies as financial institutions for F.A.T.C.A. purposes, that was found to be inconsistent with the I.G.A. definition of a financial institution. An amendment to the domestic regulations clarified that a holding company will only be considered a financial institution for F.A.T.C.A. purposes if it meets the definition of one of the four financial institution categories set out in the I.G.A. Otherwise, the holding company should be classed either as an "active" or "passive" non-financial foreign entity, as the circumstances dictate.

C.R.S.

Ireland is a signatory jurisdiction to the Multilateral Competent Authority Agreement on Automatic Exchange of Finance Account Information, which was entered into by Ireland in its capacity as a signatory to the Convention on Mutual Administrative Assistance on Tax Matters. Ireland has introduced legislation to implement the O.E.C.D.'s common reporting standard ("C.R.S.") internationally and to implement Directive 2014/107/E.U. on Administrative Cooperation in the field of Taxation ("D.A.C.2") with respect to the exchange of information between E.U. Member States. The C.R.S. has been effective in Ireland since January 1, 2016, with first reporting to the Irish tax authorities scheduled for no later than June 30, 2017.

State Aid Investigation

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

The European Commission published its much anticipated decision on the Apple case on December 19, 2016, against which both Apple and the Irish Government have lodged appeals with the Court of Justice of the European Union. The Department of Finance is in negotiations with Apple over setting up a holding account for the €13 billion the European Commission says is due to Ireland in back taxes, pending the outcome of the appeals. While the appeals process is ongoing – and several years are expected to pass before a conclusion is reached – the money will be held in escrow and invested in a managed account in order to maintain its value.

A.T.A.D.

The Anti-Tax Avoidance Directive ("A.T.A.D.") was adopted as Council Directive 2016/1164/E.U. on July 12, 2016, and must be implemented by all E.U. Member States by January 1, 2019. Among the measures in the A.T.A.D. is an interest limitation rule which closely follows the provisions of B.E.P.S. Action 4, whereby "exceeding borrowing costs" of corporate taxpayers in E.U. Member States are deductible in the tax period in which they are incurred up to 30% of the taxpayer's E.B.I.T.D.A. The implementation date for the interest limitation rule in Ireland may be deferred beyond January 1, 2019, to the earlier of (i) the end of the first fiscal year following the date of publication of the agreement between O.E.C.D. Member States on a minimum standard with regards to B.E.P.S. Action 4, and (ii) January 1, 2024. Ireland has indicated it will avail itself of the option to defer implementation to January 1, 2024, as in its view it already has domestic interest limitation rules.

A.T.A.D. 2

The A.T.A.D. 2 extends the hybrid mismatch definition of the A.T.A.D. to include mismatches resulting from arrangements involving permanent establishments, hybrid transfers, imported mismatches, and reverse hybrid entities. Broadly, Member States must transpose local provisions by December 31, 2019. Ireland may be required to implement amending legislation in order to bring its law into line with the A.T.A.D. 2 in respect to third country mismatches. Those mismatches involve interest paid on a debt instrument issued by an Irish tax resident entity that is deductible on a current basis in Ireland while the recipient in a third country entity benefits from a participation exemption upon receipt of the payment.

CORPORATE TAX RATE

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

The applicable rate of Irish tax on passive income is 25%. (Dividends, however, may be taxed at the 12.5% rate, depending on the circumstances, as discussed in **Dividends Received by Irish Companies** below.) This rate of tax is low compared with other jurisdictions. In addition, Ireland's double tax treaty network is likely to give a credit for overseas tax.[1] In most cases, the credit will exceed the 25% rate of tax applied in Ireland, resulting in a zero liability to Irish tax. In the absence of a treaty between Ireland and the other jurisdiction, or where a treaty gives inadequate relief, Ireland's generous system of unilateral credit relief will reduce, if not eliminate, the Irish tax imposed on the income of a holding company.

DIVIDENDS RECEIVED BY IRISH COMPANIES

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

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

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

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

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

Where dividends are paid by one of these companies on a shareholding of less than 5%, the dividends are deemed to have been paid out of trading profits. Thus,

---

[1] Ireland has signed double taxation treaties with 72 countries, all of which are in effect.

the 12.5% rate will automatically be applicable. Where the profits of the company paying the dividend are at least 75% trading profits and meet either of the above conditions, a dividend will be deemed to be paid wholly out of trading profits, and thus, the 12.5% rate will automatically apply once again. In other cases, an apportionment will be needed to determine the part of the dividend to which the 12.5% rate applies and the balance, which will remain liable at 25%.

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

With a 12.5% rate payable on most dividends and foreign tax credit availability ¬– including "onshore pooling," which enables excess credits derived from high-tax subsidiaries to be offset against dividends from low tax subsidiaries – it is commonly possible to avoid Irish tax arising in a group holding company.

DIVIDENDS PAID BY IRISH HOLDING COMPANIES

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

The Irish legislation implementing the E.U. Parent-Subsidiary Directive ("P.S.D.") allows an Irish company to make distributions free of withholding tax to E.U.-resident companies that comply with the conditions of the directive (*i.e.*, being a certain type of E.U. Member State company and paying tax in an E.U. Member State) and hold at least 5% of the share capital of the Irish company. No documentation requirements exist to preclude the application of this exemption.

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

- a person, not being a company, who is neither resident nor ordinarily resident in Ireland and who is, by virtue of the law of an E.U. Member State or of a treaty country, resident for tax purposes in that country;
- a company that is resident in an E.U. Member State (other than Ireland) or in a treaty country, and which is not under the direct or indirect control of a person, or persons, resident in Ireland; and
- a company that (i) is neither a resident of Ireland nor a resident of any other E.U. Member State or a treaty country, and (ii) is under the ultimate indirect control of a person that is resident in an E.U. Member State (other than Ireland) or in a treaty country.[2]

---

[2] Where there is a chain of ownership, the exemption does not apply if an Irish-resident company is in the chain.

Note, however, that if the majority of voting rights in the parent company are controlled directly or indirectly by persons who are neither resident in an E.U. Member State nor resident in a country with which Ireland has an income tax treaty in effect, the exemption will apply only if the parent company exists for *bona fide* commercial reasons and does not form part of any arrangement for which a main purpose is the avoidance of income tax, corporation tax, or capital gains tax.

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

EXEMPTION FROM CAPITAL GAINS TAX ON THE SALE OF FOREIGN SHARES

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

- At the time of the disposal, the foreign company is resident, for tax purposes, in the E.U. or in a treaty country.
- The company making the disposal must be, directly or indirectly, beneficially entitled to (i) at least 5% of the company's ordinary share capital, (ii) at least 5% of the profits available for distribution to the shareholders of the company, and (iii) at least 5% of the assets of the company available for distribution to shareholders upon a winding up of the business.
- The disposal must occur during an uninterrupted period of 12 months during which the Irish company (i) directly or indirectly holds at least 5% of the ordinary share capital of the company, (ii) is beneficially entitled to at least 5% of the profits available for distribution to the shareholders, and (iii) would be beneficially entitled upon a winding up to at least 5% of the assets of the company available for distribution to the shareholders of the subsidiary whose shares are being disposed of, or within 24 months of the last such uninterrupted period.
- At the time of the disposal of shares in an investee company (*i.e.*, the foreign subsidiary), either the investee company must carry on a trade, or the business of the investor company (*i.e.*, the Irish holding company), its subsidiaries, and the investee company and its subsidiaries, taken as a whole, consist wholly or mainly of trading.

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

FINANCING THE IRISH HOLDING COMPANY – INTEREST PAYMENT DEDUCTIONS

Until the A.T.A.D. rules come into effect in 2019,[3] Ireland does not have thin capitalization rules. Therefore, an Irish holding company can be financed principally by way of debt. An Irish tax deduction is potentially available for interest on monies borrowed to finance the acquisition of shares. Interest is allowed as a deduction if it is used in acquiring any part of the ordinary share capital of (i) a trading company, (ii) a company whose income consists mainly of real estate rental income, or (iii) a holding company of one of these companies. A deduction is also allowed for interest on funds lent to these companies, if the funds are used wholly and exclusively for the purposes of the borrower's trade or business, or that of a company connected with it.

"Until the A.T.A.D. rules come into effect in 2019, Ireland does not have thin capitalization rules. Therefore, an Irish holding company can be financed principally by way of debt."

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

Interest paid by an Irish company to a non-Irish resident that is a 75% parent can be characterized as a nondeductible distribution under Irish law. This recharacterization does not apply if the parent is tax resident in an E.U. Member State. If the parent is a resident of the U.S. for the purposes of the Ireland-U.S. Income Tax Treaty, a nondiscrimination article in the treaty should override the Irish domestic recharacterization. In addition, an Irish company can elect not to have the interest treated as a distribution, provided that (i) the company is a trading company, (ii) the payment is a distribution only because it is payable to a nonresident company of which the Irish company is a 75% subsidiary or associate, (iii) the amount is payable in the ordinary course of the Irish company's trade, and (iv) the payment would not otherwise be deductible.

FINANCING OF THE IRISH HOLDING COMPANY – INTEREST WITHHOLDING TAX

If the Irish holding company is financed by way of debt, it will be required to pay interest to its lenders. Interest paid by an Irish company to a nonresident of Ireland is

[3] See **A.T.A.D. 2**, above.

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 a relevant income tax treaty, an exemption exists under domestic law. Interest paid by an Irish holding company to a company that is resident in an E.U. Member State or a treaty country (*i.e.*, "relevant territories") is exempt from the withholding tax, provided the relevant territory imposes a tax that generally applies to interest received by companies in the relevant territory from an outside source. There is an exception where the interest is paid to such a company in connection with a trade or business carried out in Ireland.

TREATY NETWORK

Ireland has signed double taxation agreements with 72 jurisdictions, listed below, all of which are currently in effect.

Albania	Armenia	Australia	Austria
Bahrain	Belarus	Belgium	Bosnia & Herzegovina
Botswana	Bulgaria	Canada	Chile
China	Croatia	Cyprus	Czech Republic
Denmark	Egypt	Estonia	Ethiopia
Finland	France	Georgia	Germany
Greece	Hong Kong	Hungary	Iceland
India	Israel	Italy	Japan
Kuwait	Latvia	Lithuania	Luxembourg
Macedonia	Malaysia	Malta	Mexico
Moldova	Montenegro	Morocco	Netherlands
New Zealand	Norway	Pakistan	Panama
Poland	Portugal	Qatar	Romania
Russia	Saudi Arabia	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sweden	Switzerland	Thailand
Turkey	United Arab Emirates	United Kingdom	United States
Ukraine	Uzbekistan	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. Notably, Irish domestic law grants a tax treatment more favorable than that given by the treaties.[4]

CAPITAL DUTY

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

---

4 See **Dividends Received by Irish Companies** above, regarding tax credits for foreign dividends.

STAMP DUTY ON SHARES

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

LIQUIDATION DISTRIBUTIONS BY THE HOLDING COMPANY

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

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

C.F.C., THIN CAPITALIZATION, AND TRANSFER PRICING RULES

Ireland currently has no C.F.C. rules, although this is likely to change with the implementation of the relevant A.T.A.D. provisions in Ireland. Apart from the recharacterization rules under which interest may be treated as a dividend, and certain anti-avoidance provisions restricting interest deductibility in certain intra-group debt scenarios, Ireland does not have thin capitalization rules.

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

RELEVANT ANTI-AVOIDANCE PROVISIONS

Ireland does not have any relevant anti-avoidance provisions.

CONCLUSION

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

SPAIN

Author
Guillermo Canalejo Lasarte
Uria Menéndez
Madrid, Spain

A Spanish holding company, or "*entidad de tenencia de valores extranjeros*" (familiarly known by its Spanish acronym "E.T.V.E."), is an ordinary Spanish company subject to 25% tax on its income, but fully exempt from taxation on qualified domestic- and foreign-source dividends and capital gains.

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

Subject to the Anti-Tax Avoidance Directive ("A.T.A.D.") of the E.U., E.T.V.E.'s are protected by E.U. directives such as the Parent-Subsidiary Directive ("P.S.D.") and the Merger Directive, and are regarded as Spanish residents for tax purposes pursuant to Spain's 92 bilateral tax treaties currently in force.

Listed below are the jurisdictions that have income tax treaties with Spain that are currently in force and effect as of May 8, 2017:

Albania	Algeria	Andorra	Argentina
Armenia	Australia	Austria	Barbados
Belarus	Belgium	Bolivia	Bosnia & Herzegovina
Brazil	Bulgaria	Canada	Chile
China	Colombia	Costa Rica	Croatia
Cuba	Cyprus	Czech Republic	Dominican Republic
Ecuador	Egypt	El Salvador	Estonia
Finland	France	Georgia	Germany
Greece	Hong Kong	Hungary	Iceland
India	Indonesia	Iran	Ireland
Israel	Italy	Jamaica	Japan
Kazakhstan	Kuwait	Kyrgyzstan	Latvia
Lithuania	Luxembourg	Macedonia	Malaysia
Malta	Mexico	Moldova	Morocco
Netherlands	New Zealand	Nigeria	Norway
Oman	Pakistan	Panama	Philippines
Poland	Portugal	Romania	Russia

Saudi Arabia	Senegal	Serbia	Singapore
Slovenia	Slovakia	South Africa	South Korea
Sweden	Switzerland	Tajikistan	Thailand
Trinidad & Tobago	Tunisia	Turkey	Turkmenistan
Ukraine	United Arab Emirates	United Kingdom	United States
Uruguay	Uzbekistan	Venezuela	Vietnam

Spain's extensive tax treaty network with Latin America, coupled with the European characteristics of the E.T.V.E., make it an attractive vehicle for channeling capital investments in Latin America as well as a tax-efficient exit route for E.U. capital investments, subject, of course, to the limitations of the P.S.D. when the principal shareholder of the E.T.V.E. is based outside the E.U.

Spain has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

EXEMPTION ON QUALIFIED DOMESTIC- AND FOREIGN-SOURCE INCOME

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

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

QUALIFIED DOMESTIC AND FOREIGN INVESTMENTS

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

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

Minimum Stake and Holding Period

The equity of the subsidiary may be represented by shares, quotas, or other forms of capital interest. Dividends will be exempt at the level of the E.T.V.E. even if

“Nonresident subsidiaries must be subject to and not exempt from a tax of a nature similar to Spanish C.I.T., with a nominal tax rate of at least 10%.”

the one-year holding period requirement is satisfied after the dividends have been received. In comparison, capital gains will be exempt only if the one-year holding period requirement has been met on the date of transfer.

The 5% stake requirement must be met by the E.T.V.E. on the direct and indirect holding of any first-tier subsidiary. Alternatively, the acquisition value of the stake in the first-tier nonresident subsidiary must exceed €20 million.[1]

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

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

Subject To and Not Exempt From Tax

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

Determining the degree of compatibility between foreign tax systems and the Spanish C.I.T. is difficult. A tax of a similar nature will include any foreign tax levied on the income of the nonresident subsidiary, even if levied on a partial basis. For the purposes of this test, it is irrelevant whether the object of the foreign tax is the nonresident subsidiary’s income, turnover, or any other index-linking element of the nonresident subsidiary. This requirement will be deemed to be met if the nonresident subsidiary resides in a tax-treaty country, provided the treaty contains an exchange of information clause. All current treaties entered into by Spain contain exchange of information clauses.[2]

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:[3]

---

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

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

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

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

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

Active Nonresident Subsidiary

A company is considered non-active when more than half of its assets are made up of securities or are not linked to an active trade or business. Securities representing at least 5% of the share capital of a company that are held for a year are not considered for this purpose, so long as (i) the holding company holds the stake with the aim of managing and controlling its interest in the subsidiary with the necessary human and material resources, and (ii) the subsidiary is not a non-active company.[4]

Prior to January 1, 2015, the E.T.V.E. regime applied to nonresident subsidiaries only if they were considered to be active. The active requirement was eliminated as of January 1, 2015. However, capital gains arising from the transfer of non-active companies will only qualify for the exemption up to the amount of the non-active company's retained earnings generated during the period of time that the E.T.V.E. owned such a subsidiary. Excess capital gains will be taxable pursuant to the ordinary rules of the C.I.T. Law. Similarly, capital gains arising from the transfer of a nonresident company subject to the Spanish controlled foreign corporation ("C.F.C.") rules (see below) will not qualify for the exemption in any amount.

Qualified Holding Company

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

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

[4] Article 5 of the C.I.T. Law.

- The Spanish holding company informs the Spanish tax authorities that it opts to be subject to the provisions of the Spanish holding company regime.

Corporate Purpose

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

It is not necessary for the E.T.V.E. to control and manage the actual activities of the invested companies, but rather that it manage the stake in the company. The Spanish tax authorities have interpreted this requirement flexibly.

Material and Human Resources

This requirement is closely related to the previous requirement.

The Spanish General Tax Directorate (the "D.G.T."), the administrative body in charge of drafting and interpreting tax legislation, clarified this essential requirement for E.T.V.E. in three non-binding rulings dated May 22, 2002, December 20, 2002, and March 31, 2004, and in one binding ruling issued on October 29, 2003. The requirement has been confirmed in more recent binding rulings, dated March 16, 2016 and July 5, 2016.

The D.G.T. takes the view that the proper human and material resources requirement is met, *inter alia*, if the day-to-day management of the E.T.V.E. is vested in one or more directors of the company who have been granted sufficiently broad powers of attorney to allow the vested directors to manage the E.T.V.E. The vested director or directors must be 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 that the E.T.V.E. control and manage the activities of the invested companies. All that is required is the control and management of the stake.

Finally, all D.G.T. rulings are framed within the context of the E.U. Code of Conduct and the policy of the Economic and Financial Affairs Council ("E.C.O.F.I.N.") to eliminate harmful tax competition within the E.U. Moreover, specific decisions of courts in other European countries, such as the decision of the Tax Court of Cologne of June 22, 2001, interpret "substance" using similar reasoning.

Filing with the Spanish Tax Authorities

An E.T.V.E. must notify the Spanish tax authorities of its intention to apply the holding company tax regime. In addition, the Spanish holding company may submit binding ruling requests on the interpretation of the regulations and requirements of the regime. The special tax regime will come into effect in the E.T.V.E.'s first fiscal period ending after the notice is filed.

Deduction of Costs

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

A capital loss realized upon the transfer of the shares of a domestic or nonresident subsidiary is deductible, subject to certain limitations.

LIQUIDATION LOSSES

Subject to certain limitations, a loss realized upon the liquidation of a nonresident subsidiary is deductible, unless it is liquidated as a result of a restructuring transaction.

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

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

Otherwise, dividends distributed by an E.T.V.E. will be subject to the standard 19% withholding tax or the reduced bilateral tax treaty rate, as applicable.

Dividends paid by an E.T.V.E. to its E.U.-resident shareholder will not be subject to the dividend withholding tax, provided that the E.U. shareholder meets the following conditions:

- It takes one of the forms set out in the Annex to the P.S.D.
- It is subject to, and not exempt from, tax as listed in Article 2(c) of the P.S.D.
- It owns directly at least 5% of the share capital of the E.T.V.E.
- It has held the stake for at least 12 months immediately preceding the dividend payment, or continues to hold the participation until the one-year period is completed.[5]

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

---

5 In the latter case, the withholding will be levied upon distribution and the E.U.-resident shareholder will be entitled to claim a refund once the one-year holding period has elapsed.

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

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

Capital gains triggered by nonresident shareholders on the disposal of Spanish shares are normally subject to a 19% tax.

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

"Exempt income earned through an E.T.V.E.'s foreign permanent establishment would be treated as qualified exempt income of the E.T.V.E. when earned (in the form of dividends or capital gains) by its nonresident shareholder."

Also, in an income tax treaty context, capital gains on the disposal of shares in an E.T.V.E. will generally not be subject to Spanish taxation. Some income tax treaties ratified by Spain, such as the income tax treaty with the U.S.,[6] allow Spain to tax capital gains at the general 19% tax rate, provided that the foreign shareholder holds a substantial stake in the Spanish entity (usually more than 25% of the capital).

Finally, there are some additional domestic exemptions available to E.U.-resident shareholders, who will also benefit from an exemption on capital gains triggered by the disposal of a stake in an E.T.V.E. (or any other Spanish-resident company). The exemption applies when the E.T.V.E. does not derive its value, whether directly or indirectly, mainly from real estate located in Spain. In addition, if the E.U. resident is an individual, he or she must not have held an equity interest of 25% or more at any

[6] On January 14, 2013, the U.S. and Spain signed a protocol amending the 1990 income tax treaty that is currently in effect. The protocol includes significant changes to foster the efficiency of reciprocal direct investment in the U.S. and Spain. In particular, it brings withholding tax rates and other provisions in line with the tax treaties in force between the U.S. and most E.U. countries, effectively eliminating the need for complex and costly investment planning structuring.

In most cases, the protocol eliminates taxation at the source, creating significant savings and increasing net yields. Capital gains will be taxed only at the 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.

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

time during the 12-month period preceding the disposal of the interest. If the E.U. resident is an entity, the participation exemption requirements set out in Article 21 of the C.I.T. Law must be met with respect to the E.T.V.E. These requirements were previously explained, above.

LIQUIDATION OF AN E.T.V.E.

The liquidation of an E.T.V.E. triggers recognition of capital gains not subject to withholding tax, but taxable as described in **Capital Gains on Transfer of E.T.V.E.** A liquidation will also trigger capital duty unless specific or special provisions apply (see **Capital Duty** below).

OTHER INCOME TAX ISSUES

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

In 2012, the Spanish Parliament ring-fenced the use of these potentially abusive schemes by enacting Royal Decree-Law 12/2012, amending the C.I.T. Law. For C.I.T. purposes, the Decree prohibits deductions for financial expenses on intra-group indebtedness incurred to (i) acquire an interest in the share capital or equity of any type of entity from another group company or (ii) increase the share capital or equity of any other group companies. The disallowance is not applicable when sound business reasons exist for the transaction.

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

CORPORATION INCOME TAX

Rate

An E.T.V.E. is subject to the 25% C.I.T. on income other than qualified dividends and capital gains, as previously explained.

Interest Barrier Rule

Royal Decree-Law 12/2012 has replaced the thin capitalization rules with a general restriction on the deduction of financing expenses. The scope of thin capitalization rules was limited in cross-border transactions because they did not apply to debts with residents in the E.U. Decree 12/2012 establishes that net financing expenses exceeding 30% of the operating profit of a given tax year (subject to specific adjustments) 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.

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

Other Nondeductible Expenses

Impairment allowances for share capital or equity investments in companies are generally not deductible. As an exception, impairment is deductible as a result of the transfer or disposal of the participation, provided the following requirements are met during the prior year:

- The participation is less than 5%.
- In the case of participation in the capital of nonresident entities, the subsidiary (i) has been subject to (and not exempt from) a foreign tax identical (or analogous in nature) to C.I.T. at a nominal rate of at least 10% or (ii) is resident in a country with which Spain has ratified a tax treaty that contains an exchange of information clause.

Payments on Account Against C.I.T.

During the tax year, C.I.T. taxpayers are required to file three estimated payments on account for their C.I.T. liability for the current year. If the tax year coincides with the calendar year, the payments on account must be made during the first 20 days of April, October, and December.

Typically, an E.T.V.E. would not be required to make a tax payment to the extent its income qualifies for the participation exemption. However, as a consequence of an amendment made in October 2016,[7] C.I.T taxpayers with net turnover of at least €10 million (including dividends and capital gains in the case of an E.T.V.E.) in the 12 months prior to the beginning of the tax period are obliged to make a minimum payment equivalent to 23% of the accounting result (without taking into account tax adjustments, such as tax exemptions or tax credits).[8]

As a result, an E.T.V.E. may be required to make a payment on account, which will eventually be refunded. There are certain options to minimize this financial cost, such as deferring the earning of the E.T.V.E.'s income to the last month of the taxable year, because the last month of the period is not covered by a payment on account.

---

[7] Royal Decree Law 2/2016 of September 30, introducing tax measures intended to reduce the public deficit.

[8] The conformity of this amendment and minimum payment with constitutional principles is questionable.

Capital Duty

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

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

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

Transfer Pricing

According to the C.I.T. Law, Spanish companies are obliged to enter transactions with related parties (defined in Article 18.2 of the C.I.T. Law) on an arm's length basis. In other words, the transaction value of the controlled transaction must be arm's length. In accordance with the O.E.C.D. Guidelines, the comparable uncontrolled price method, the cost plus method, the resale price method, the profit split method, or the transactional net margin method may be used to determine the arm's length value of a controlled transaction.

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

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

For the taxable year beginning on January 1, 2016, country-by-country reporting is required for operations of multinational groups based in Spain. These reporting requirements will apply also to a Spanish company that is a member of a foreign-based group when (i) its nonresident parent company is not required to make a country-by-country filing in its country of tax residence and (ii) the foreign-based group has a consolidated annual turnover exceeding €750 million.

Finally, in order to resolve the issue of transfer pricing on a preliminary basis, the C.I.T. Law establishes the possibility of submitting a preliminary proposed valuation of transactions between related parties to the authorities in order to obtain an advance pricing agreement or "A.P.A.").

The Spanish C.I.T. regulations detail the procedure for evaluating A.P.A.'s submitted to the tax authorities. Taxpayers must submit detailed documentation together with specific proposals, depending on the type of A.P.A.

With respect to international transactions, the regulations adopt a special procedure

"Spanish tax authorities have been encouraging taxpayers to submit A.P.A. proposals. Even though these agreements have not been customary in the past, the tax authorities seem to be flexible when evaluating proposals."

for a four-party agreement between the Spanish tax authorities, the tax authorities of the other country, the Spanish taxpayer, and its foreign affiliate.

Spanish tax authorities have been encouraging taxpayers to submit A.P.A. proposals. Even though these agreements have not been customary in the past, the tax authorities seem to be flexible when evaluating proposals.

Controlled Foreign Corporations

An E.T.V.E., like any other Spanish-resident company, is subject to C.F.C. rules, or the *transparencia fiscal internacional*. Under the C.F.C. rules, specific income generated by a foreign entity can give rise to C.I.T. for an E.T.V.E. if (i) the E.T.V.E. has a minimum 50% stake in the entity's capital, equity, profits and losses, or voting rights; (ii) the income is subject to tax at an effective rate that is less than 75% of the rate under Spanish C.I.T. in comparable circumstances; and (iii) the income is tainted income (*e.g.*, financial income, dividends, passive real estate income, and royalties).

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

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

Recent B.E.P.S. Developments

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

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

UNITED KINGDOM

Authors
Eloise Walker
Penny Simmons
Pinsent Masons LLP
London, U.K.

INTRODUCTION

This summary of U.K. law is correct as of June 5, 2017.

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

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

Individuals

The U.K. has a unique taxation system for individuals who are resident but not domiciled in the U.K. known as the "remittance basis." Individuals who are eligible to use the remittance basis are only liable to U.K. tax on foreign-source income and capital gains to the extent that those amounts are remitted to the U.K. This system has made the U.K. an attractive and cost-effective center for locating foreign executives.

Non-domiciled individuals ("Non-Doms") seeking to benefit from the remittance basis must pay a tax charge if they have been resident in the U.K. for seven or more of the last nine tax years. The charge, known as the remittance basis charge ("R.B.C."), increases as the period of U.K. residence increases:

- **£90,000:** Applicable to Non-Doms that have been resident in the U.K. for 17 of the last 20 tax years (the "17-year test")
- **£60,000:** Applicable to Non-Doms that do not meet the 17-year test but have been resident in the U.K. for 12 of the last 14 tax years (the "12-year test")
- **£30,000:** Applicable to Non-Doms that do not meet the 12-year test but have been resident in the U.K. for seven of the last nine years

When the R.B.C. was first introduced, it applied as a single £30,000 charge for individuals resident in the U.K. for seven of the last nine years. Since then, the R.B.C. has been amended and increased several times, in various attempts to restrict tax benefits for individuals that have been resident in the U.K. for an extended period. Consequently, different levels of the R.B.C. may apply for individual tax years between April 2008 and April 2017.

In July 2015, the government announced wide-ranging changes to the rules on domicile. It was expected that from April 2017 onwards, individuals who had been resident in the U.K. for at least 15 of the previous 20 tax years would be deemed to be domiciled in the U.K. from the beginning of the sixteenth tax year.

Consequently, these individuals would no longer be eligible to claim the remittance basis and would be taxed in the U.K. on their worldwide income and gains. As a result, the £90,000 R.B.C., which applies under the 17-year test, would become redundant as of April 2017.

Legislation to introduce these changes was expected to be included in Finance Act 2017. However, following the U.K. government's decision to hold a general election on June 8, 2017, many provisions, including the changes to the taxation of Non-Doms, were removed from the Finance Bill 2017 so that a substantially shortened bill could be passed before the U.K. Parliament was dissolved. While the changes are still expected to be introduced, it remains uncertain whether the provisions will be included in a later finance bill this year and will take retrospective effect from April 6, 2017, or whether they will be delayed until Finance Bill 2018 and take effect from April 6, 2018.

An important R.B.C. relief was introduced in 2012. As of April 2012, foreign income and gains may be brought into the U.K. for the purpose of investing in certain U.K. companies without constituting a taxable remittance that is subject to U.K. tax. The relief applies to investments in private U.K. companies only. Broadly, the investment can be made by way of shares or debt and must be made within 45 days of the funds being brought into the U.K. The relief will not be available where the funds are being remitted as part of a scheme or arrangement to avoid U.K. tax.

It should be noted that during the summer of 2016, the U.K. government consulted on possible changes to this relief, in order to further encourage investment in U.K. companies by Non-Doms. Changes to the relief were expected to be introduced in Finance Act 2017 and to take effect from April 6, 2017. However, the provisions were withdrawn from Finance Act 2017 before it received royal assent on April 27, 2017. It is currently unclear when the changes will be introduced. A statement from the U.K. government clarifying the position will not be published until after the general election on June 8, 2017.

Foreign executives coming to work in the U.K. should also be aware of certain measures, introduced in Finance Act 2014, to combat the misuse of artificial dual contracts by non-domiciled employees. Broadly, the rules prevent U.K.-resident Non-Doms from electing to use the remittance basis for overseas employment income where these individuals are artificially separating U.K. and overseas employment duties by creating separate employment contracts with a U.K. employer and an associated overseas employer.

A statutory residence test ("S.R.T.") was introduced in April 2013 to determine whether an individual is tax resident in the U.K. The S.R.T. is designed to give individuals greater certainty and clarity as to whether they are tax resident in the U.K. and therefore subject to U.K. income tax and capital gains tax ("C.G.T.") on their worldwide income and gains. Individuals should note that their tax residence status under the S.R.T. may differ from their tax residence in years prior to the introduction of the S.R.T.

Corporations

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

- The U.K. has competitive corporate income tax rates. The main rate of U.K. corporate income tax is currently 19% (reduced from 20% in April 2016). The main rate of U.K. corporate income tax is due to be further reduced to 17% in April 2020.

- An exemption from corporate income tax is available for most dividends received from U.K.- and foreign-resident companies, and is backed up by a foreign tax credit system where the exemption does not apply.

- No withholding tax is levied on dividends paid by U.K. companies to nonresident shareholders, except for distributions made by certain types of investment funds, such as real estate investment trusts ("R.E.I.T.'s").

- The U.K. offers an exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups. However, it should be noted that during 2016, the U.K. government consulted on changes to the substantial shareholding exemption. Legislation effecting changes was expected to be introduced in Finance Act 2017 and to take effect from April 1, 2017. However, as with many other legislative tax changes, the provisions were withdrawn from Finance Act 2017 to allow a substantially shortened Finance Act to be passed before the general election on June 8, 2017. There is no C.G.T., in general, on the sale of shares in U.K. companies by nonresidents.

- There are no capital taxes on formation or paid-in capital of companies.

- The U.K. has an optional "Patent Box" regime, introduced in April 2013 as part of the U.K. strategy to incentivize innovation, and the development and retention of certain intellectual property rights in the U.K. Broadly, the regime allows qualifying companies to elect to apply a lower rate of U.K. corporate income tax on all profits attributable to qualifying patents, whether paid as royalties or embedded in the price of the products. The relief was phased in over five years, and as of April 1, 2017 provides an effective corporate income tax rate of 10% on worldwide profits attributable to qualifying patents and similar I.P. rights. However, the Patent Box was closed to new entrants after June 30, 2016 and will be abolished for existing claimants by June 30, 2021. Developments to the Patent Box regime follow recommendations from the O.E.C.D. published in October 2015. From July 1, 2016, a new U.K. "Patent Box" became available that is based on the "modified nexus" approach. This approach looks more closely at the jurisdiction where the R&D expenditure incurred in developing the patent or product actually takes place. It seeks to ensure that substantial economic activities are undertaken in the jurisdiction in which a preferential I.P. regime exists, by requiring tax benefits to be connected directly to the R&D expenditure. Further changes to the new Patent Box regime were expected to be introduced in Finance Act 2017, to ensure that where R&D is undertaken collaboratively by two or more companies under a "cost sharing arrangement," the companies involved are treated neutrally and are not disadvantaged or advantaged by the arrangement. The rules were expected to apply to accounting periods beginning from April 1, 2017. The changes were withdrawn from the pre-election Finance Act 2017 and it is currently uncertain when they will be reintroduced.

- There is an above-the-line R&D Expenditure Credit ("R.D.E.C.") for qualifying companies that incur qualifying R&D expenditure on or after April 1, 2013. The R.D.E.C. is calculated directly as a percentage of the company's R&D expenditure and subsidizes the R&D. The credit is recorded in a company's accounts as a reduction in the cost of R&D – that is, it is recorded above the tax line. For large companies, the R.D.E.C. is payable at 11%. A separate regime allowing for a tax deduction of 230% of qualifying R&D expenditure

“The U.K. will formally leave the E.U. by March 2019. . . . It is currently anticipated that all existing E.U. law, including previous decisions by the C.J.E.U., will continue to apply to the U.K. after the point of its withdrawal.”

for small- or medium-sized companies (“S.M.E.’s”) is also available provided certain conditions are met.

- The U.K. has the most extensive tax treaty network in the world, covering around 130 countries.
- There has been official confirmation that the U.K. will not introduce a financial transactions tax (“F.T.T.”). It remains a possibility that the E.U. will introduce an F.T.T. Irrespective of the fact that the U.K. is expected to have withdrawn from the E.U. by March 2019, the U.K. had previously announced that it would not introduce a F.T.T. unless it was introduced on a global basis in order to safeguard the competitiveness of the U.K.’s financial services market.

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

- the *Franked Investment Income/Foreign Dividend Group Litigation*[1] (see below),
- *Cadbury Schweppes plc v H.M.R.C.*[2] (see below), and
- the *Thin Cap Group Litigation*.[3]

As a direct result of these cases, an exemption system for foreign dividends was introduced in Finance Act 2009 and a new C.F.C. regime was legislated under Finance Act 2012. Finance Act 2009 also imposed limitations on the deductibility of intra-group interest expense of corporate groups (the “worldwide debt cap”).

Another notable C.J.E.U. decision that affects the U.K.’s status as a holding company jurisdiction is the *Marks & Spencer plc v. Halsley* decision.[4] As a result of this case, U.K. holding companies are able to claim losses incurred by subsidiaries in other E.U. Member States, under certain circumstances.

On March 29, 2017, in compliance with Article 50 of the Treaty of the European Union, the U.K. formally notified the E.U. Council of its intention to withdraw from the E.U. Written notification under Article 50 triggered formal negotiations between the U.K. and the E.U. to determine the terms of the U.K.’s withdrawal.

Despite the fact that the U.K. will formally leave the E.U. by March 2019 at the latest, to maintain legal certainty, it is currently anticipated that all existing E.U. law,

---

1 *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, Case C-446/04 [2006] E.C.R. I-11753.

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

3 *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, Case C-524/04, [2007] E.C.R. I-02107.

4 *Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes)*, Case C-446/03, [2005] E.C.R. I-10837.

including previous decisions by the C.J.E.U., will continue to apply to the U.K. after the point of its withdrawal.

CORPORATE INCOME TAX RATE

As previously noted, the main rate of U.K. corporate income tax is 19%. This rate is currently due to be reduced to 17% from April 2020.

U.K. Companies

A company tax resident in the U.K. is liable to U.K. corporate income tax on its worldwide income and gains. Generally, capital gains realized by a U.K. company are included in profits for the purposes of calculating corporate income tax, and taxed at the same rate as income (currently 19%). However, there are exceptions to this rule, such as for gains realized on disposals of U.K. residential real estate assets (see below).

For U.K. corporate income tax purposes, trading profits are calculated by deducting certain reliefs and allowances together with expenses incurred wholly and exclusively for the purpose of the trade. Trading profits are taxed on an accruals basis and, generally, in accordance with the financial accounting treatment for determining profits and losses. The U.K. permits the use of U.K. generally accepted accounting principles ("G.A.A.P."), or the International Accounting Standards in the case of companies whose shares are listed on an exchange in the E.U. Generally, capital gains are taxed on realization.

Non-U.K. Companies

Generally, a company that is not tax resident in the U.K. is liable to U.K. tax only on certain items of U.K.-source income and gains, such as rental income. Most other U.K. income is taxable only to the extent that U.K. tax is withheld at the source, such as on certain interest payments.

However, a non-U.K. company may still be liable for U.K. corporate income tax if it trades in the U.K. through a U.K. permanent establishment, such as a branch or agent. In this case, the nonresident company would be liable for U.K. tax on worldwide income and gains related to that permanent establishment.

Certain non-U.K. companies (and other U.K. and non-U.K. "non-natural persons") that hold certain high-value (*i.e.*, over £500,000) U.K. residential real estate assets are subject to an annual charge (the "annual tax on enveloped dwellings" or "A.T.E.D."). The A.T.E.D. amount increases as the value of the real estate asset increases. The lowest rate is currently £3,500 (for real estate valued at more than £500,000 but less than £1,000,000), whilst the top rate is currently £220,350 (for real estate valued at more than £20 million).

Originally, the A.T.E.D. only applied to residential real estate assets valued at more than £2 million, but subsequent Finance Acts have extended the scope of the tax so that the A.T.E.D. applies to residential real estate assets valued over £500,000 from April 1, 2016. There are certain reliefs from the A.T.E.D. for genuine real estate development companies and rental companies.

When an asset falls within the scope of the A.T.E.D. charge, the disposal of that asset is subject to 28% C.G.T. ("A.T.E.D.-related C.G.T."). With respect to these disposals, U.K. companies will be liable to A.T.E.D.-related C.G.T., rather than U.K. corporate income tax.

Since April 6, 2015, corporate entities not resident in the U.K. are also subject to C.G.T. on gains accruing on the sale of all U.K. residential real estate assets (the "nonresident C.G.T. charge"). Any gain arising on or after April 6, 2015 is taxable at 20% unless the A.T.E.D.-related C.G.T. charge applies.

It is possible that a disposal may fall within the scope of both the A.T.E.D.-related C.G.T. charge and the nonresident C.G.T. charge. In such circumstances, A.T.E.D.-related C.G.T. is applied first, and then the nonresident C.G.T. charge is applied only to gains that are not subject to A.T.E.D.-related C.G.T.

It should be noted that the nonresident C.G.T. charge for gains realized on disposals of U.K. residential real estate assets also applies to individuals, trustees, and personal representatives. The rate of the charge is 18% or 28% for individuals (depending on the person's overall taxable income and applicable income tax rate) and 28% for trustees and personal representatives.

DIVIDENDS RECEIVED BY U.K. COMPANIES

In principle, all dividends or other distributions received by U.K.-resident companies – no matter where the income arises ¬– are subject to U.K. corporate income tax, unless specifically exempt.

Distributions received by companies, other than small companies, are exempt if that distribution (i) falls into an exemption, (ii) does not represent a payment of interest deemed to be a distribution, and (iii) does not qualify for a tax deduction with respect to a resident of any territory outside the U.K. under the laws of that territory.

The exemptions are widely drafted, and in practice, most distributions received by a company will fall under one of the following exemptions:

- **Distributions from controlled companies.** Broadly, this exemption applies when the recipient, alone or in conjunction with others, is in control of the company, in accordance with the relevant definition of control.
- **Distributions with respect to non-redeemable ordinary shares.** This exemption will cover most distributions with respect to ordinary shares by U.K. companies.
- **Distributions with respect to portfolio holdings.** Broadly, these are holdings of less than 10%.
- **Dividends derived from transactions not designed to reduce tax.**
- **Dividends with respect to shares accounted for as liabilities of the issuer under G.A.A.P.** These payments are usually taxed under different provisions.
- **Capital distributions made from reserves arising from a reduction in capital.** Distributions that are capital in nature and which fall outside of the "dividend exemption" may be subject to U.K. corporate income tax on

chargeable gains, unless the substantial shareholding exemption or another exemption or relief is available.

Several anti-avoidance provisions exist to prevent artificial avoidance or manipulation of these exemptions. Targeted schemes include, *inter alia*, deductions given for distributions, payments effected on non-arm's length terms, and diversions of trade income. In addition, other anti-avoidance rules, including the general anti-abuse rule ("G.A.A.R.") (discussed in **Corporate Criminal Offenses of Failing to Prevent Tax Evasion** below), may prevent a taxpayer from claiming exemptions in certain cases.

The recipient of an exempt distribution can elect not to apply an exemption with respect to a particular distribution. The election must be made within two years of the end of the accounting period in which the distribution is received.

FOREIGN TAX CREDIT FOR U.K. COMPANIES

Where the exemptions described above do not apply, double taxation issues may arise if a U.K. corporate recipient of a non-U.K. dividend would be subject to both U.K. tax and foreign tax in the jurisdiction from which the dividend is paid. To combat this, tax relief may be available under the provisions of a double tax treaty between the U.K. and the relevant foreign jurisdiction.

Where an income tax treaty is not in place to provide relief, a credit is generally granted against U.K. tax for foreign withholding tax levied on non-U.K. dividends. A U.K. tax credit will not be available if the relevant income tax treaty expressly denies relief in the form of a tax credit under these circumstances.

"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."

Generally, companies pay dividends out of taxed profits. If a nonresident pays foreign tax on profits out of which a dividend is paid, the foreign tax payment is referred to as an "underlying tax." In the U.K., an indirect foreign tax credit may be allowed for underlying tax where the recipient is a U.K. tax resident company (an "underlying tax credit"). Typically, this underlying tax credit will only be available where the U.K. recipient company has a substantial interest in the foreign payer.

Broadly, to meet the substantial interest standard, the recipient must directly or indirectly control, or be a subsidiary of a company that indirectly or directly controls, 10% or more of the voting power of the payer company. However, in limited circumstances, the underlying tax credit may be available where the 10% control condition is not strictly met.

For the purpose of the underlying tax credit, underlying tax will generally include underlying tax from related companies through an indefinite number of successive levels in the corporate chain. For this purpose, two companies are associated if the shareholder receiving the dividend, directly or indirectly, controls 10% or more of the voting power in the paying company. A U.K. tax credit given for foreign tax will be reduced or denied if a foreign tax authority has repaid any amount of the foreign tax paid to (i) the recipient of the U.K. tax credit, (ii) any person connected with the recipient, or (iii) a third party as a result of a scheme (which is broadly defined).

Source of Income

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

Credit Pooling

Previously, the U.K. had a relatively complex regime of “onshore pooling” of foreign tax credits, allowing excess foreign tax credits from one source to be applied against the U.K. tax due on other foreign-source dividends. However, this regime has been discontinued. In the majority of cases, there will now be no U.K. tax liability levied on the corporate recipient of an overseas dividend and, therefore, there is no need for a credit pooling system to relieve any associated U.K. tax liability.

Anti-Avoidance

A broad anti-avoidance rule, specifically aimed at foreign tax credits, exists to combat arrangements designed to secure excessive foreign tax credits, such as “dividend buying” schemes, where extra income is deliberately purchased to enhance the foreign tax credit of the purchaser. The rule applies where four conditions are satisfied:

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

Broadly, schemes or arrangements are those which

- enable attribution of foreign tax, when the foreign tax is properly attributable to another source of income or gains;
- concern the effect of paying foreign tax, so that on entering the scheme it would be reasonable to expect that the total amount of foreign tax would be increased by less than the amount allowable as a tax credit;
- involve deemed foreign tax, where an amount is treated as if it were foreign tax paid and either no real foreign tax would reasonably be expected to be paid or it would be reasonable to expect that the increase in foreign tax credit allowed exceeds the increase in actual tax paid;
- concern claims or elections for tax credits the effect of which is to increase or give rise to a claim for a relief by way of a tax credit;
- would reduce a person’s tax liability; or
- involve tax-deductible payments.

H.M.R.C. will issue a counteraction notice where it has reasonable grounds to determine that the above criteria have been met. Taxpayers will then have 90 days to determine whether to (i) accept H.M.R.C.'s application of the legislation and amend their self-assessment tax return as required, or (ii) disregard the counteraction notice. Disputes regarding the application of the rules will be resolved through the normal self-assessment examination and appeals procedure. Where the counteraction notice is successfully invoked, the tax credit claim will be limited so as to cancel the effect of the scheme or arrangement.

Different rules apply where the underlying tax of a nonresident company is involved. In such circumstances, the counteraction will apply where, had the nonresident company that paid the foreign tax been a U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company.

Hybrid Instruments

In certain limited circumstances, it may be possible for a foreign dividend, which is not exempt from U.K. corporate income tax, to give rise to a tax credit for the U.K. corporate recipient and also be deductible for the foreign payer for foreign tax purposes. Where this occurs, the U.K. corporate recipient will not obtain a U.K. tax credit for underlying foreign tax. The denial of credit for underlying foreign tax is automatic and not limited to instruments created or assigned for the purpose of obtaining the benefit of the credit.

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

There is no U.K. withholding tax on dividends paid by U.K. companies to U.S. shareholders as the U.K. does not impose withholding tax on dividends to nonresident shareholders as a matter of domestic law.

However, U.K. withholding tax at 20% applies to property income distributions ("P.I.D.'s") paid in relation to certain qualifying activities by R.E.I.T.'s that are resident in the U.K. This may be reduced by an applicable U.K. income tax treaty. A company will not be able to qualify as a R.E.I.T. if it has corporate shareholders with a 10% or greater participation. In those circumstances, tax will be withheld at the rate applicable to portfolio dividends. This rate currently is 15% for qualified U.S. residents under the U.K.-U.S. Income Tax Treaty. The position is essentially the same with respect to the 20% withholding that applies to P.I.D.'s made by property-authorized investment funds.

DIVERTED PROFITS TAX

The Diverted Profits Tax ("D.P.T.") is a U.K. tax aimed at multinationals operating in the U.K. that artificially siphon profits out of the U.K. or try to avoid a taxable establishment by playing the complexities of the tax system. It is primarily an anti-avoidance measure and was introduced in Finance Act 2015.

The current rate of D.P.T. is 25% of the diverted profit. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Given that the rate of U.K. corporation tax is currently 19% (and set to be reduced further), it is expected that companies affected by D.P.T. will seek to restructure operations, so as to derive profits in the U.K.

D.P.T. applies to diverted profits arising on or after April 1, 2015, although there were apportionment rules for accounting periods that straddled that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or permanent establishment and there are arrangements between connected parties which "lack economic substance" in order to exploit tax mismatches. One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity in a tax haven.
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a permanent establishment in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax, or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. (This is referred to as the "avoidance of a U.K. taxable presence.")

D.P.T. does not apply to S.M.E.'s.

Where companies or permanent establishments lack economic substance, there are two tests that must be considered: (i) the insufficient economic substance condition, and (ii) the effective tax mismatch condition. If either test is met, a D.P.T. charge will be payable.

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit, and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction. Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person's involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that have a real financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party.

There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, or to certain offshore funds or authorized investment funds.

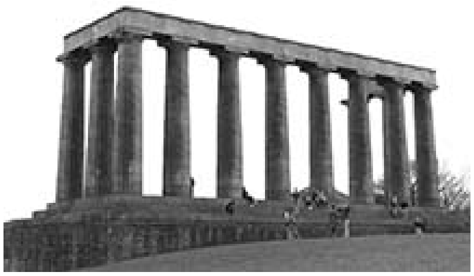
Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied, or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporate income tax charge.

There will not be an avoidance of a U.K. taxable presence if the U.K. activity is undertaken by someone acting as an agent of independent status or for the purposes of alternative finance arrangements.

There are also specific exceptions from a D.P.T. charge if, in a 12-month accounting period, U.K.-related sales are below £10,000,000, or U.K.-related expenses are below £1,000,000.

Calculating the D.P.T. charge is complex and various rules must be considered. Broadly, it will be necessary to consider profits that would have arisen if the company made a full transfer pricing adjustment. It will also be necessary to determine the amount of profit that would have arisen from an alternative transaction that would have reasonably taken place if a tax reduction had not been relevant to the parties.



No taxable diverted profits should arise if, in the relevant transactions, the company made transfer pricing adjustments that put it in the same tax position as if arm's length pricing had been used.

D.P.T. has its own specific rules for assessment and payment. D.P.T. is not self-assessed; rather, companies have to notify H.M.R.C. if they are potentially within the scope of D.P.T. and do not satisfy any of the exemptions.

Following notification, if H.M.R.C. considers a company potentially liable for D.P.T., it will issue a preliminary notice to the company calculating the D.P.T. and outlining the grounds on which they consider D.P.T. to be payable. H.M.R.C. must issue a preliminary notice within two years of the end of the accounting period in which the D.P.T. charge arose. A company then has 30 days to contact H.M.R.C. to correct obvious errors in the notice, following which H.M.R.C. must either issue a charging notice stating the amount of D.P.T. payable, or notify the company that no D.P.T. is payable. The company then has 30 days from receipt of the charging notice to pay any D.P.T. due. There is no right to appeal the preliminary notice or charging notice prior to payment and there are no grounds for delaying payment.

Following payment, H.M.R.C. has 12 months to review the charge to D.P.T. During this time, the charge may be reduced or increased. The company can only appeal a D.P.T. charge after the 12-month review period has ended.

There is no formal clearance procedure for D.P.T., although it may be possible to obtain a written opinion from H.M.R.C. on the likelihood a D.P.T. notice will be issued.

C.G.T. EXEMPTION ON THE DISPOSAL OF SUBSTANTIAL SHAREHOLDINGS

Any gains realized on a U.K. company's disposal of shares in an operating company may be exempt from U.K. tax if the gains qualify under the Substantial Shareholding Exemption (the "S.S.E."). The S.S.E. is available only if several conditions are satisfied by the company making the disposal (the "investing company") and the company that issued the shares being sold (the "target company"). The conditions are detailed and complex, but broadly, the S.S.E. will be available if

1. the investing company holds a substantial shareholding in the target company, which is at least 10% of the target company's ordinary share capital, and the investing company is beneficially entitled to not less than 10% of the profits available for distribution and 10% of the assets on a winding-up of the

target company;

2. the investing company is a sole trading company or a member of a trading group;

3. the target company is a trading company, or a holding company of a trading group, or of a trading sub-group; and

4. conditions 1 through 3 above are met for a period of at least 12 months, beginning not more than two years before the day on which the disposal occurs.

The target company does not need be a U.K.-resident company for the S.S.E. to apply.

With regard to conditions 2 and 3, a trading company, generally, is a company that (i) carries out a trading activity, and (ii) activities other than trading activities are not carried on "to a substantial extent." A trading group has a similar definition, where one or more members carry on a trading activity and, when taken together, the activities of the group members do not include "to a substantial extent" activities other than trading activities. For these purposes, H.M.R.C. considers the term "substantial" to mean more than 20%.

"Any gains realized on a U.K. company's disposal of shares in an operating company may be exempt from U.K. tax if the gains qualify under the Substantial Shareholding Exemption."

For the purpose of the S.S.E., a company will form part of a group if it is a 51% subsidiary of another company (*i.e.*, the parent). A company will be a 51% subsidiary of another company if the parent owns, directly or indirectly, more than 50% of the ordinary share capital of the subsidiary. When determining whether a group is undertaking trading activities, the group is treated as a single business.

The trading requirement for the investing and target companies must be satisfied immediately after the disposal. The precise definition of what constitutes a trading activity is detailed and is based on both legislation and case law.

Satisfying the conditions of the S.S.E. may prove problematic in joint venture scenarios. The investing company may have difficulty satisfying the trading requirement if it holds a substantial interest in the joint venture and the holding is considered an investment rather than a trading activity.

Consequently, special rules apply to investments in certain joint ventures. Broadly, a holding of at least 10% in the ordinary share capital of a joint venture company will not dilute the trading activity of the investing company. If the investing company is a member of a group, holdings of different group members can be aggregated for this purpose. However, the aggregate holding must be less than 51%, since the investing company cannot be in the same group as the joint venture company.

In this context, the joint venture company must be a trading company, or the holding company of a trading group or trading sub-group, and at least 75% its ordinary shares must be held by five or fewer persons.

In certain circumstances, the S.S.E. may also be available to exempt taxable gains realized on the disposal of shares in a company engaged in oil and gas exploration.

The S.S.E. legislation includes an anti-avoidance provision that applies in certain circumstances and is aimed at denying relief under the exemption where arrangements have been made with the sole or main purpose of securing the exemption.

With the benefit of the S.S.E. and other aspects of the U.K. tax system, the sale of a trading business in the U.K. can now be structured to ensure that no taxable gains arise from the principal sale, although a restructure of the target through the hive-down of certain intangibles, debt assets, and trading stock may trigger tax charges. Nonetheless, some businesses can be hived-down to a newly-established subsidiary in a tax-free transfer that is followed by a sale of the newly-formed subsidiary which benefits from the S.S.E. exemption.

Gains derived from disposals of shareholdings that do not meet the requirements of the S.S.E. will be liable to U.K. corporate income tax. Consequently, capital losses should be allowable but may only be offset against capital gains of the company.

At the 2016 Budget, the U.K. government announced its intention to review the S.S.E. legislation to determine whether amendments are needed to improve the U.K.'s competitiveness as a holding company location. Following a consultation during the summer of 2016, the U.K. government confirmed that it would be introducing several changes to the S.S.E. In brief, the proposed changes are

- the removal of the condition that the investing company must be a trading company or part of a trading group;
- the extension of the condition that the investment must have been held for at least a continuous period of 12 months in the two years preceding the sale, to 12 months in the six years preceding the sale; and
- the withdrawal of the condition that the company whose shares are sold continues to be a qualifying company immediately after the sale, except where the sale is to a connected party.

The legislation effecting the changes was expected to be included in Finance Act 2017 and to take effect from April 1, 2017. However, as noted above, the provisions were withdrawn from Finance Act 2017 to allow a substantially shortened Finance Act to be passed before the general election on June 8, 2017. It is currently unclear when these provisions will be reintroduced and whether they will still take effect from April 1, 2017.

CAPITAL GAINS ON THE DISPOSAL OF SHARES BY A NONRESIDENT

Generally, no U.K. tax is payable on the disposal of shares in a U.K. company by a nonresident shareholder. A limited exception exists in the case of shares in oil companies whose value is based on exploration or exploitation rights in the U.K. sector of the North Sea. C.G.T. may also be payable on gains realized from the disposal of shares forming part of the assets of a U.K. branch of a nonresident company.

In certain circumstances, anti-avoidance provisions relating to U.K. real property may trigger a liability to income tax on the sale of shares of companies whose value is based on U.K. real estate.

CAPITAL TAX AND STAMP DUTY

In the U.K., there is no capital tax on the formation of a company or on any capital paid in. No stamp duty is paid on share subscriptions.

Transfers of shares of U.K. companies are generally liable to stamp duty or stamp duty reserve tax ("S.D.R.T.") at 0.5% of the consideration for the sale, albeit various exemptions may apply. For example, exemptions exist for certain intra-group transfers and transfers of shares on "recognized growth markets," such as the Alternative Investment Market ("A.I.M.") and the I.C.A.P. Securities & Derivatives Exchange ("I.S.D.X.").

Technically, stamp duty is a tax on documents. Therefore, U.K. stamp duty is payable on the sale of non-U.K. shares if the transfer document is signed in the U.K. Stamp duty must be paid by the purchaser within 30 days of signing. Failure to meet this deadline can result in penalties and interest.

A higher rate of stamp duty or S.D.R.T. of 1.5% may be charged where shares and securities are issued or transferred into a clearing system or a depository receipt facility. However, this increased charge has been successfully challenged under E.U. law. Consequently, in practice, the higher charge will only apply to transfers of U.K. shares or securities into a clearing system, or depository receipt facility, if the transfer is not an integral part of an issue of share capital or raising of capital. However, the legitimacy of this higher charge and its compatibility with E.U. law, particularly the free movement of capital, remains questionable.

Finance Act 2016 contains a new provision to ensure that the transfer of U.K. securities into a depository receipt facility, or clearance system following the exercise of an option, will give rise to a 1.5% stamp duty or S.D.R.T. charge on the greater of the fair market value or option strike price, as of the date of the transfer. The new provision applies to options exercised on or after March 23, 2016.

This change has been introduced to combat the avoidance of U.K. stamp duty and S.D.R.T. arising on the transfer of shares using Deep-in-the-Money Options ("D.I.T.M.O.'s"). An option is a D.I.T.M.O. when the strike price is significantly below fair market value.

TAX TREATY NETWORK

As noted above, the U.K. has one of the most extensive tax treaty networks in the world – treaties are in effect with approximately 130 jurisdictions, listed below.

Albania	Algeria	Antigua & Barbuda	Argentina
Armenia	Australia	Austria	Azerbaijan
Bahrain	Bangladesh	Barbados	Belarus
Belgium	Belize	Bolivia	Bosnia & Herzegovina
Botswana	British Virgin Islands	Brunei	Bulgaria
Canada	Cayman Islands	Chile	China
Croatia	Cyprus	Czech Republic	Denmark
Egypt	Estonia	Ethiopia	Falkland Islands
Faroe Islands	Fiji	Finland	France
Gambia	Georgia	Germany	Ghana
Greece	Grenada	Guernsey	Guyana

Hong Kong	Hungary	Iceland	India
Indonesia	Isle of Man	Israel	Italy
Ivory Coast	Jamaica	Japan	Jersey
Jordan	Kazakhstan	Kenya	Kiribati
Kosovo	Kuwait	Latvia	Lesotho
Libya	Liechtenstein	Lithuania	Luxembourg
Macedonia	Malawi	Malta	Mauritius
Mexico	Moldova	Mongolia	Montenegro
Montserrat	Morocco	Myanmar	Namibia
Netherlands	New Zealand	Nigeria	Norway
Oman	Pakistan	Panama	Papua New Guinea
Philippines	Poland	Portugal	Qatar
Romania	Russia	Saudi Arabia	Senegal
Serbia	Sierra Leone	Singapore	Slovakia
Slovenia	Solomon Islands	South Africa	South Korea
Spain	Sri Lanka	St. Kitts & Nevis	Sudan
Swaziland	Sweden	Switzerland	Taiwan
Tajikistan	Thailand	Trinidad & Tobago	Tunisia
Turkey	Turkmenistan	Tuvalu	Uganda
Ukraine	United Arab Emirates	United States	Uruguay
Uzbekistan	Venezuela	Vietnam	Zambia
Zimbabwe			

The U.K. has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Broadly, the U.K. treaty negotiating position aims to

- reduce the risk of double taxation where the same income is taxable in two states;
- provide certainty of treatment for cross-border trade and investment;
- prevent excessive foreign taxation and other forms of discrimination against U.K. business interests abroad; and
- protect the U.K.'s taxing rights against attempts to evade or avoid U.K. tax.

The latter point has become a driver for U.K. tax treaty policy, consistent with E.U. and O.E.C.D. policies.

The extensive U.K. treaty network is also significant in reducing or eliminating non-U.K. taxes on payments made to recipients that are U.K. tax resident. One specific aim of U.K. treaty policy is the elimination of withholding tax on interest and royalties. About one-quarter of the U.K. treaties achieve this goal. The remaining treaties typically reduce withholding tax rates. U.K. tax treaties also commonly exempt disposals of shares from C.G.T. in the source state.

Additionally, almost all U.K. treaties reduce foreign withholding tax on dividends. In any event, where a U.K. or other E.U. company owns at least 10% of the shares in another E.U. company, the E.U. Parent-Subsidiary Directive ("P.S.D.") operates to eliminate any withholding tax on dividends paid by the subsidiary company to the parent company. It is unlikely that U.K. companies will be able to benefit from the P.S.D. once the U.K. has left the E.U., however, this cannot be confirmed until the precise terms relating to the U.K.'s exit from the E.U. have been agreed.

Pursuant to the European Interest and Royalties Directive, intra-group interest and royalty payments may also be free of withholding tax when paid to an associated company in another E.U. Member State. Again, it is not expected that the U.K. will be able to benefit from the European Interest and Royalties Directive after it has left the E.U.

It should also be noted that following Finance Act 2016, royalty payments made between connected parties on or after March 17, 2016 are denied any benefit conferred by a U.K. double tax treaty if a main purpose of the arrangement is to secure a benefit that is contrary to the purpose of the relevant treaty. This can be viewed as an attack on holding companies that do not serve a business function separate from a reduction of withholding taxes.

DEBT FINANCING OF U.K. COMPANIES

The Deductibility of Interest Expense – Current Position

Currently, the U.K. allows a company to deduct most forms of interest expense and other debt finance costs from its corporate income tax profits, therefore reducing a company's liability to U.K. corporate income tax.

The tax deductibility of interest and other corporate finance costs is determined according to the U.K.'s "Loan Relationships" rules, which govern the taxation of corporate debt. Broadly, a loan relationship exists if there is a "money debt" that arose from a transaction for the lending of money. This is the case where a company, within the scope of U.K. corporate income tax, is either a debtor or a creditor. A money debt, for this purpose, is one that is satisfied by the payment of money or the transfer of rights under a debt that is itself a money debt. Where a company issues an instrument as security for a money debt, a loan relationship similarly exists.

The Loan Relationships regime contains several anti-avoidance provisions to restrict excessive interest deductions in certain circumstances. One such provision is the "unallowable purpose rule," which operates to restrict a tax deduction where the relevant loan relationship has been entered into for an unallowable purpose. Broadly, a loan relationship will have an unallowable purpose if the transaction is entered into for non-commercial reasons, or reasons that do not have a business justification for the company. The exact scope and application of the unallowable purpose rule is complicated and there has been a significant amount of case law on its application.

A "targeted anti-avoidance rule" has also been introduced that applies to arrangements entered into from November 18, 2015. The rule is very widely drafted and could potentially apply to any financing transaction where the main or one of the main purposes is to obtain a tax advantage. The rule operates to counteract any tax advantage that may result from the transaction, including an interest expense deduction. The U.K. G.A.A.R. provisions may also operate to restrict an interest deduction in certain circumstances.

A restriction on the deductibility of interest expense may also be imposed by the U.K.'s thin capitalization rules, which are contained in the transfer pricing legislation. Under these rules, an interest deduction may be disallowed in certain circumstances. Currently, the thin capitalization rules do not have fixed ratios or safe harbors regarding the extent to which interest is deductible.

The Worldwide Debt Cap

In addition to the foregoing anti-abuse provisions, the operation of the U.K.'s worldwide debt cap rules may result in the imposition of a restriction on deductions of interest expense.

The worldwide debt cap operates to restrict the amount of interest that can be claimed by the U.K. members of a multinational group by reference to the group's total consolidated external finance costs. Broadly, the restriction applies to any worldwide group where the net U.K. debt of the group exceeds 75% of the gross worldwide debt. For this purpose, net U.K. debt of any company less than £3 million is disregarded.

Broadly, the total disallowed amount of the worldwide group is the excess of the aggregate relevant financing expense of U.K.-resident group companies and permanent establishments of nonresident members, over equivalent amounts of the worldwide group. In calculating the aggregate financing expense, net financing expenses of a company below £500,000 are disregarded. The disallowed amount may be allocated among relevant companies as determined by the group, but failing proper allocation, it is apportioned by formula. Where a disallowance arises, a corresponding exemption applies to the financing income of relevant companies. Financing income received may also be exempt if the payer is a tax resident of an E.E.A. territory and is denied relief for payment. Exclusions apply to financial services groups, group treasury companies, charities and exempt bodies, stranded management expenses in non-trading loan relationships, R.E.I.T.'s, foreign branches, oil extraction companies, shipping operations within the tonnage tax, property rental businesses, and intra-group short-term financing. Qualifying securitization companies are also excluded.

The future of the worldwide debt cap remains uncertain in light of anticipated changes to the rules on interest deductibility (see below).

The Future of Interest Deductibility in the U.K.

Prior to the U.K. prime minister's decision to hold a general election on June 8, 2017, it had been expected that new rules restricting tax deductions for corporate interest payments would apply from April 1, 2017. Draft legislation detailing the new restriction had been published in March 2017 for inclusion in Finance Bill 2017. However, following the announcement regarding the general election, the draft provisions for the new rules were removed from Finance Act 2017, which received royal assent (becoming law) on April 27, 2017.

At the time of writing, it is uncertain whether the draft legislation will be enacted in a second finance bill this year and therefore still have effect from April 1, 2017. Depending on the outcome of the general election, it is possible that the draft legislation could be included as part of a second Finance Bill in the summer of 2017, or deferred to be enacted later. Although such things are never certain, it is probable that the legislation will eventually be enacted in something similar to its current form whatever the outcome of the general election, since it is rare for a measure so far advanced (and so lucrative for H. M. Treasury) to be abandoned.

Background to the New Rules – the B.E.P.S. Project

The U.K. government's decision to restrict the tax deductibility of corporate interest payments has been driven by international pressure following the recommendations of the O.E.C.D.'s efforts to combat base erosion and profit shifting (the "B.E.P.S. Project").

The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis. Following international recognition that the global tax system needed reforming to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an Action Plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments (Action Item 4).

Action Item 4 focused on limiting B.E.P.S. via interest deductions, and specifically, on whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

In October 2015, the O.E.C.D. published its final recommendations in relation to Action Item 4. It recommended the introduction of a general interest limitation rule that should operate by restricting interest deductions by reference to a fixed ratio of a company's earnings before interest, taxes, depreciation and amortization.

The O.E.C.D. did not specify the level of this ratio; rather, it advocated that countries should choose an E.B.I.T.D.A. ratio of between 10% and 30%.

The O.E.C.D. recommended that there should be an optional exclusion for interest on loans used to fund public-benefit projects. The rationale for this is that certain public benefit projects are considered to have a low tax avoidance risk.

The O.E.C.D. also recommended introducing a number of safeguards to address any potential volatility that the rule may create. These included a *de minimis* threshold for low-risk entities and carryforward provisions, whereby disallowed interest deductions may be carried forward and deducted in a future accounting period.

The O.E.C.D. also suggested that jurisdictions should consider introducing suitable transitional rules, particularly to enable existing third-party debt to be excluded or "grandfathered" from the ambit of the new restrictions.

Overview of the New U.K. Rules

Under the new U.K. rules (if enacted as currently contemplated), tax relief for interest and certain other financing costs will be limited to 30% of tax E.B.I.T.D.A., which will broadly be profits chargeable to corporate income tax, excluding interest, tax depreciation such as capital allowances, tax amortization, relief for losses brought forward or carried back, and group relief claimed or surrendered.

When applying the rules, groups will generally need to work out the tax E.B.I.T.D.A. of each U.K.-resident member company and each U.K. permanent establishment, and add them together. The limit on deductible interest will be 30% of that figure.

There will be a *de minimis* allowance of £2 million per annum, which means that groups with a net interest expense below this threshold will be unaffected by the fixed ratio rule.

A company will be able to carry forward *indefinitely* interest expense that has been restricted under the rules. The carried forward interest may then be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period, it will be able to carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after *five years*.

"If it gets a better result for the group . . . the G.R.R. will be used as an alternative to the 30% fixed ratio rule."

The new restrictions will apply to interest on existing loans as well as new loans, although limited grandfathering will be available in certain circumstances (see below).

It is also intended that the current worldwide debt cap will be repealed and replaced by new legislation that will have a similar effect.

Group Ratio Rule

The new rules will include a group ratio rule ("G.R.R.") based on the ratio of net interest to E.B.I.T.D.A. for the worldwide group. The G.R.R. will also allow deductions up to the ratio of net interest to E.B.I.T.D.A. for the worldwide group if it exceeds the fixed ratio. This is intended to help groups with high external gearing for genuine commercial purposes by substituting the G.R.R. for the fixed ratio rule if it gets a better result for the group.

The G.R.R. will be calculated by dividing the net *qualifying* group interest expense by the group E.B.I.T.D.A. When calculating the G.R.R., whilst net interest is essentially calculated in the same way as for the fixed ratio rule, the worldwide "group E.B.I.T.D.A." is an accounting measure; it broadly equals the consolidated profit before tax of the worldwide group, adjusted for depreciation and net interest.

The G.R.R. will be used as an alternative to the 30% fixed ratio rule. The total amount of the deductions available under the G.R.R. will be capped at 100% of tax-E.B.I.T.D.A.

Interest on related-party loans, perpetual loans, and results-dependent loans will not be included in the calculation of the G.R.R.

Earlier drafts of the legislation provided that a third-party loan guaranteed by a related party would constitute related-party debt, which would have resulted in many commercial loans being ineligible for the G.R.R. However, following extensive lobbying from industry, the draft legislation has been revised and now provides that a loan will not be treated as having been made by related parties where (i) a guarantee is provided by a member of the debtor's group, (ii) financial assistance is only provided in relation to shares in the ultimate parent entity, (iii) the loans are made to a member of the group, or (iv) the financial assistance is a non-financial guarantee. Limited grandfathering is also available for guarantees provided prior to April 1, 2017.

Public Infrastructure Exemption

To maintain investment in the U.K.'s infrastructure sector, there will be an exclusion for interest paid on public infrastructure projects, known as the Public Infrastructure Exemption ("P.I.E."). Infrastructure projects tend to be highly-geared and their viability is often dependent on the availability of debt financing. Without a specific exclusion, many infrastructure projects would not get off the ground due to lack of affordable debt financing and difficulty raising equity finance.

The P.I.E. will only be available if an election is made and will only apply to companies where all or (significantly all) of their income and assets relate to activities involving public infrastructure assets.

Meaning of Public Infrastructure Assets

For this purpose, public infrastructure assets will include

- tangible U.K. infrastructure assets that meet a "public benefit test"; or
- buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties.

The public infrastructure asset must also have or be likely to have an expected economic life of at least ten years, and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset will meet the public benefit test if it is procured by a relevant public body (such as a government department, local authority, or health service body) or will be used in the course of an activity that is or could be regulated by an "infrastructure authority." This second limb should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset.

The exemption will also apply to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a "qualifying infrastructure asset" if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. Here, "short-term basis" means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

Third-Party Debt Requirement

The P.I.E. will only apply to interest paid to third parties where the recourse of the creditor is limited to the income, assets, shares, or debt issued by a qualifying infrastructure company (not necessarily the borrower).

Guarantees from parent companies or non-infrastructure companies within the group could prevent the exemption from applying. However, guarantees provided before April 1, 2017 and certain non-financial guarantees (relating to providing the services) will now be ignored.

Grandfathering Provisions

Although the new restrictions will apply to interest on existing loans, limited grandfathering (where existing arrangements are taken outside the scope of the new rules) will be available for infrastructure companies within the P.I.E. where

- loan relationships were entered into on or before May 12, 2016; and
- where at least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years was highly predictable by reference to certain public contracts.

Originally, no grandfathering was proposed. However, there were significant concerns that without it some existing infrastructure projects would go into default, particularly those with shareholder debt, such as many existing private finance initiatives or similar projects, which may find it difficult to restructure. Take, for example, infrastructure projects involving U.K. schools and hospitals that are highly geared for genuine commercial reasons and whose viability is dependent on the tax deductibility of the project's interest expense. These projects may have commenced ten years ago and may still have 20 or more years left to run; a restriction on tax relief could be catastrophic to the continued viability of such projects.

After much lobbying by industry, grandfathering was introduced for these projects. The grandfathering exemption will apply to interest on loans between related parties if the conditions are satisfied.

A transitional provision also applies in the first year to enable groups to restructure to fall within the P.I.E.

Administration of the New Rules

The new rules will operate by assessing the level of interest in the worldwide group and therefore any restriction on the deductibility of interest cannot be processed through a company's normal U.K. corporation tax return. U.K. companies will also need to file an interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies to them. If a company elects to complete the short-form interest restriction return, it will not be able to use its interest allowance in a later period, although it will have 60 months to revoke its election and submit a full return.

Groups must appoint a reporting company to make the return. This is a company that is not dormant and is a U.K. group company, or a group member subject to U.K. corporate income tax for at least part of the relevant period to which the return relates.

Withholding Tax on Interest

Generally, a U.K. company has a duty to withhold tax on U.K.-source payments of yearly interest. Currently, the rate of withholding is 20%. Broadly, "interest" will constitute "yearly interest" if it relates to debt that is intended to extend beyond one year.

There are a number of exemptions to this general rule. For example, there is

“The U.K.’s anti-arbitrage rules were replaced with new anti-avoidance rules, known as the ‘anti-hybrid rules’ . . . based on the O.E.C.D.’s final recommendations in relation to Action Item 2 of the B.E.P.S. Project.”

currently no withholding tax on payments of interest to U.K. banks and U.K. corporation taxpayers.

Quoted Eurobonds also benefit from an exemption from U.K. withholding tax. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized exchange.

As explained above, bilateral tax treaties may also reduce the amount of withholding tax payable on interest payments to non-U.K. lenders. Administrative burdens arise when a reduction is claimed under a treaty.

As of January 1, 2016, an exemption was introduced for certain qualifying private placements. A private placement is a type of unlisted debt instrument that is sold by way of a private offering to a small number of investors. The exemption is intended to encourage the use of private placements as an alternative form of financing.

The exemption will apply only to a security under the loan relationship rules. Therefore, it must be a money debt, as previously discussed. The term of the security must not be more than 50 years, and the aggregate value of the securities contained in the private placement must be at least £10 million.

The exemption will be available only if the debtor holds a certificate from the creditor, confirming that (i) the creditor is resident in an approved territory and is beneficially entitled to the interest in the private placement for genuine commercial reasons, and (ii) the private placement is not being held as part of a tax avoidance scheme. Broadly, a country will be an approved territory if it has been designated as such by other U.K. tax regulations or it has a double tax agreement with the U.K. and the tax agreement has a non-discrimination article.

Debtors are also required to have entered into the private placement for genuine commercial reasons and not as part of a tax advantage scheme.

Following the introduction of Finance Act 2017, from April 6, 2017, certain open ended investment companies (“O.E.I.C.’s”), authorized unit trusts (“A.U.T.’s”) and investment trust companies (“I.T.C.’s”) no longer have to withhold U.K. tax on interest distributions that are treated as payments of yearly interest.

ANTI-ARBITRAGE LEGISLATION

Prior to January 1, 2017, the U.K. had legislation to counter tax avoidance using arbitrage schemes that involved *inter alia*, hybrid entities. Where the rules applied, a deduction for corporate income tax purposes was denied to U.K. companies if, and to the extent that, more than one deduction was available for the same expense, whether in the U.K. or elsewhere, and the income accruing or arising under the scheme was taxed only once.

As of from January 1, 2017, the U.K.’s anti-arbitrage rules were replaced with new anti-avoidance rules, known as the “anti-hybrid rules.” These new rules are based on the O.E.C.D.’s final recommendations in relation to Action Item 2 of the B.E.P.S. Project. Action Item 2 focuses on the avoidance of tax using hybrid-mismatches. These arrangements exploit tax rules in different countries to enable a multinational to avoid paying tax in either country or to access excessive tax relief by deducting the same expense in more than one country. The U.K.’s new anti-hybrid rules are contained in Finance Act 2016. Broadly, the new rules operate to deny a U.K. tax deduction, or bring an amount within the charge to U.K. tax in intra-group transactions and third-party arrangements where certain "structured arrangements" exist, as defined by the rules.

CONTROLLED FOREIGN CORPORATIONS

Background

The U.K. has anti-avoidance rules to combat tax avoidance using C.F.C.'s. A C.F.C. is a company that is resident outside the U.K. for tax purposes and controlled by one or more persons resident in the U.K. The objective of the U.K.'s C.F.C. regime is to prevent the artificial diversion of U.K.-taxable profits to subsidiaries or other corporate entities in low-tax jurisdictions.

In certain circumstances, the regime operates to attribute profits of the C.F.C. to a U.K.-resident company in the form of a C.F.C. charge. In 2010, the regime was substantially amended, largely as a result of successful challenges regarding the compatibility of the regime with E.U. law.

Overview of the Current Regime

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

The rules widely define the meaning of U.K.-source income for the purposes of the C.F.C. regime. There are five categories of income that are regarded as U.K.-source and they are mutually exclusive:

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

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

- shareholder control ("legal control"),
- ownership or entitlement to assets ("economic control"), and
- the treatment of the company as an undertaking by the U.K. parent for accounting purposes, even if consolidated accounts are not formally required ("accounting control").

There are five exemptions that operate to either reduce or exempt the profits falling within the C.F.C. charge. These are assessed at the entity level and 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 that looks at the rate of tax paid or payable by the C.F.C.).

Virtually every provision in the C.F.C. regime contains an anti-avoidance rule based on the presence of an intent to obtain the tax benefit as a principal reason for casting a transaction through a C.F.C. As indicated above, these will apply in addition to G.A.A.R.

Under the rules, a U.K. company will not be liable to a C.F.C. charge unless it holds a qualifying interest in the C.F.C., which, broadly, is ownership of at least 25% of share capital.

There is an important exemption for finance companies that satisfy certain conditions. This exemption can be full or 75% (the "finance company partial exemption"). Where the finance company partial exemption applies, the finance C.F.C. will suffer an effective U.K. tax rate of 5% when the U.K. corporate income tax rate is 19% (the rate for the 2017-2018 tax year).

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

The use of C.F.C. rules as a tax avoidance tool was reviewed by the O.E.C.D. as part of the B.E.P.S. Project. In the 2016 Budget, the U.K. government confirmed that it did not intend to make further changes to the rules as a result of the O.E.C.D.'s recommendations. It considers the current regime to be in line with the O.E.C.D.'s recommendations.

In January 2016, the E.U. Commission published an anti-avoidance tax package that included a draft directive on corporate tax avoidance, known as the Anti-Tax Avoidance Directive ("A.T.A.D."), which requires all Member States to introduce appropriate C.F.C. rules. On June 20, 2016, the E.U. Council adopted the A.T.A.D. and Member States are expected to comply with the directive by January 1, 2019. There had been concern that in order to comply with the A.T.A.D., the U.K. would need to review the compatibility of its partial company finance exemption. However, under the final version of the A.T.A.D, no substantive amendments to the U.K.'s C.F.C rules should be necessary. In any event, given that by January 2019, the U.K. will have almost finalized its withdrawal from the E.U., the binding force of the A.T.A.D over the U.K. is questionable.

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

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

A separate regime applies to the attribution of capital gains of foreign companies to U.K. residents if the foreign companies would be considered to be "close companies" had they been U.K. resident, provided a targeted anti-avoidance test is met. Broadly, a company is a close company if it is under the control of five or fewer participants or participants who are also directors.

Taxation of Foreign Branches of U.K. Companies

Reflecting the rationale behind the creation of a wide tax exemption for U.K.-resident companies on receipt of dividends (explained in **Dividends Received by U.K. Companies** above), the U.K.'s tax legislation contains a broad exemption from U.K. corporate income tax for the overseas trading profits, gains, and investment income of a branch of most U.K.-resident companies.

The term "branch" is a domestic equivalent of a permanent establishment and the calculation of profits falling within the exemption is determined in accordance with the income tax treaty between the U.K. and the jurisdiction where the permanent establishment is established. If no such treaty exists, the model O.E.C.D. treaty is used. Special and complex rules apply to determine which losses and other reliefs, such as capital allowances, can be claimed if the exemption is not applied.

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

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

Like the C.F.C. rules, the regime contains a number of anti-avoidance rules, and G.A.A.R. provisions will also apply.

V.A.T.

The U.K. charges V.A.T. on the supplies of most goods and services with notable exclusions, such as an exclusion for financial services. Currently, V.A.T. is charged at 20% ("standard rated"), although some supplies are charged at 0% ("zero rated") and others at 5% ("reduced rated"). Ultimately, the burden of V.A.T. is intended to be borne by the final consumer. As a general principle of V.A.T. law, a fully "taxable person" should be able to recover all the input V.A.T. incurred in the course of its economic activities. The term "taxable person" is a concept used by the V.A.T. legislation to describe a person who is engaged in economic activities. Conversely, V.A.T. is not recoverable by the "end user," which is the person who acquires supplies on which V.A.T. has been charged but who is unable to show that the supplies were used by it in connection with its economic activities.

The UK's V.A.T. system is based on E.U. law and once the U.K. leaves the E.U., U.K. V.A.T. laws will no longer have to comply with the E.U.'s V.A.T. laws.

Given that the U.K. raises around £115 billion a year from V.A.T., it is unlikely to be abolished, although it is unclear whether U.K. V.A.T. will continue to be based on E.U. law. It is expected that the U.K. government will opt to continue the system broadly along current E.U. lines.

However, it is possible that the U.K. government will seek to introduce changes to V.A.T. exemptions and zero-ratings. The U.K. government will also need to assess how supplies to those established in E.U. Member States will be treated, since this could impact V.A.T. recovery for U.K. financial services companies in particular.

It is established law that simply holding shares in a subsidiary in order to receive a dividend does not amount to an economic activity for V.A.T. purposes. Therefore, generally, any V.A.T. incurred on the costs of acquiring and holding shares by a parent company for the sole purpose of holding the shares is not recoverable. For the V.A.T. to be potentially recoverable, the shares must be held for some other "economic" purpose. Consequently, U.K. holding companies seeking to recover V.A.T. should take steps to ensure that they carry on an "economic activity" for V.A.T. purposes. Very broadly, this will involve carrying on a business. If this can be achieved, the V.A.T. costs on share acquisitions or disposals and takeovers may be recoverable.

The V.A.T. treatment of supplies made by holding companies came under scrutiny by the C.J.E.U. in *A.B. v. SKF*[5] and by the U.K.'s Court of Appeal in *B.A.A. Limited v. The Commissioners for Her Majesty's Revenue & Customs* (the "*B.A.A.* case").

In *A.B. v. SKF*, the sale of shares by SKF was found to be more than a mere passive disposal of securities. Instead, SKF demonstrated that it was actively involved in the management of its subsidiaries. This constituted an economic activity. In the B.A.A. case, the Court of Appeal held that the V.A.T. incurred on advisors' fees by the relevant group company, in connection with the takeover of the B.A.A. plc group in 2006, was not recoverable under the particular facts involved. Although the acquiring entity carried on an "economic activity" for V.A.T. purposes, the court found that the fees incurred by it related principally to the acquisition rather than the post-acquisition business of the acquired group.

Both these cases confirm that companies contemplating a share acquisition or disposal should be able to recover V.A.T. incurred on fees if they can show an intention to make taxable supplies. The discussion contained in the *B.A.A.* decision suggests that, possibly, this may be achieved by the acquiring entity showing an intention to supply taxable services to the target upon completion of the takeover. For example, it could supply management services in return for a fee. The intention to make taxable supplies may also be established where the acquirer is grouped for V.A.T. purposes with the target after completion of the takeover and clear evidence exists in the lead-up to the transaction that an intention to group exists. In July 2015, in the joint cases of *Larentia and Minerva*,[6] the C.J.E.U. held that a holding company that actively manages its subsidiaries should be carrying out an economic activity for

5 *Skatteverket v AB SKF*, Case C-29/08, [2009] E.C.R. I-10413.

6 *Larentia & Minerva v. Finanzamt Nordenahm*, Joined Cases C-108-109/14, [2015] E.C.R. I___ (delivered on July 16, 2015).

V.A.T. purposes. In principle, this decision recognizes that holding companies may recover V.A.T. on advisor's fees and other costs relating to a corporate takeover, where those costs have a "direct and immediate link" with the holding company's economic activities.

In 2016, the V.A.T treatment of supplies made by holding companies was considered by the Upper Tribunal in the case of *Norseman Gold Plc v. H.M.R.C.* and the First Tier Tribunal in *Heating Plumbing Supplies Ltd v. H.M.R.C.* On the facts, V.A.T recovery was denied in *Norseman Gold*, but allowed in *Heating Plumbing Supplies Ltd.* In January 2016, H.M.R.C. announced that it intended to consult on reforming the U.K.'s V.A.T.-grouping rules. At the end of December 2016, H.M.R.C. published a consultation document that expressly considered whether to make any changes following recent C.J.E.U. decisions. The consultation closed at the end of February 2017 and a response has not yet been published.

However, in May 2017, H.M.R.C. published updated guidance, confirming that V.A.T. recovery can be made where the holding company is the recipient of the supply if certain conditions are satisfied. The conditions are as follows:

- **The holding company making the claim must be the recipient of the supply.** H.M.R.C. considers this condition satisfied where the holding company has contracted for the supply, including by novation, and it has made use of, been invoiced, and paid for the supply.
- **The holding company must be undertaking economic activity for V.A.T. purposes.** This condition will be satisfied where the holding company makes or intends to make supplies of management services for consideration to its subsidiaries. The management services must be genuine and provided for a consideration that is more than nominal. Full recovery may not be possible if management services are not supplied to all subsidiaries.
- **The economic activity must involve the making of taxable supplies.** The holding company should create and retain contemporaneous evidence of its intention to make taxable supplies. Full recovery may not be possible if in addition to providing management services, the holding company makes exempt supplies in providing loans to the subsidiaries. However, the H.M.R.C. guidance now confirms that where the holding company is lending money to companies within a V.A.T. group and these loans can be seen to support the making of taxable supplies by the V.A.T. group, the related V.A.T. will be recoverable to the extent that the costs support taxable supplies made. This is the case whether the transactions within the group would be taxable or exempt supplies were they not disregarded because of the V.A.T. grouping.

G.A.A.R. AND FURTHER H.M.R.C. POWERS

G.A.A.R.

The G.A.A.R. was introduced in the U.K. in July 2013, with the broad intention of counteracting "tax advantages" arising from abusive tax arrangements. This includes obtaining or increasing relief from tax. For the purposes of the G.A.A.R. provisions, a tax arrangement includes agreements, understandings, and transactions to obtain tax relief, whether or not legally enforceable. The G.A.A.R. applies to most U.K. taxes, other than V.A.T.

The following conditions must be satisfied for the G.A.A.R. to apply:

- An arrangement giving rise to a tax advantage is present.
- The tax advantage relates to a tax covered by the G.A.A.R.
- One of the main purposes of the arrangement is to obtain the tax advantage (taking into account all facts and circumstances).
- The arrangement is "abusive."

Arrangements will be considered to be "abusive" if they cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances. This is referred to as the "double reasonableness test."

The circumstances that may be considered when ascertaining whether a transaction is abusive include (i) whether the substantive results of the arrangements are consistent with the underlying policy of the relevant provisions and any principles on which they are based, (ii) whether the means of achieving the tax advantage was contrived or abnormal, and (iii) whether the arrangement exploits any shortcomings in the legislation. The legislation sets out indications of when a transaction is likely to be abusive and includes cases where the tax position does not reflect the economic reality, such as when an interest expense deduction is greater, for tax purposes, than the amount actually paid. Arrangements that are in accordance with established and acknowledged H.M.R.C. practice will generally not violate G.A.A.R. principles.

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

Where the G.A.A.R. applies, H.M.R.C. will be entitled to counteract the tax advantage. To illustrate, it may deny a deduction for interest expense.

There is no clearance procedure enabling taxpayers to obtain confirmation from H.M.R.C. that the G.A.A.R. will not apply to a particular transaction. However, depending on the transaction type and circumstances, other clearances in comparable circumstances will be available over time.

H.M.R.C. has published Advisory Panel guidance on its interpretation of the G.A.A.R., including examples of where G.A.A.R will apply. The guidance confirms arrangements reflecting straightforward choices, such as funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, arrangements that are in accordance with long-established practice will not be subject to the G.A.A.R. unless contrived.

Disclosure of Tax Avoidance Schemes

The Disclosure of Tax Avoidance Schemes ("D.O.T.A.S.") rules were introduced in Finance Act 2004 and broadly require the promoters of certain tax avoidance schemes to disclose details to H.M.R.C. Essentially, the D.O.T.A.S. regime is intended to facilitate H.M.R.C.'s identification of potential tax avoidance schemes at an early stage, with a view to taking action to close down abusive schemes where appropriate.

Following a disclosure under D.O.T.A.S., H.M.R.C. may issue a scheme reference number ("S.R.N."). Subsequently, taxpayers who choose to use the scheme are required to put the S.R.N. on self-assessment tax returns.

Broadly, the rules apply where (i) there are "arrangements" that are expected to provide a tax advantage, (ii) receiving a tax advantage is expected to be one of the main benefits, and (iii) the scheme falls within one of several descriptions (known as "hallmarks"). Currently, the hallmarks are aimed at new and innovative schemes, marketed schemes, and targeting specific schemes.

Accelerated Payment Notices

Finance Act 2014 introduced new powers for H.M.R.C. to combat tax avoidance by way of Accelerated Payment Notices ("A.P.N.'s"). Since July 2014, H.M.R.C. has been able to demand the payment of disputed tax associated with a tax avoidance scheme upfront, before a tribunal or court has decided whether a scheme is effective. The demand is made in the form of an A.P.N., which can be issued where schemes demonstrate certain "avoidance hallmarks," such as the scheme being subject to disclosure under the D.O.T.A.S rules, or the issuance of a counteraction notice under the G.A.A.R. A.P.N.'s can be issued in relation to schemes that were entered into before the A.P.N. legislation came into force.

"Since July 2014, H.M.R.C. has been able to demand the payment of disputed tax associated with a tax avoidance scheme upfront, before a tribunal or court has decided whether a scheme is effective."

In brief, once an A.P.N. is issued, a taxpayer has 90 days to pay the tax, unless they successfully make representations to H.M.R.C. that the notice should not have been issued. However, representations can only be made on the grounds that the statutory conditions for the notice to be issued were not fulfilled, for example, that the scheme was not a D.O.T.A.S. scheme (*i.e.*, should not have been notified under the D.O.T.A.S. regime), or that the amount claimed in the A.P.N. is incorrect. There is no right of appeal against an A.P.N. Advance payments will be repaid to the taxpayer with interest in the event that the scheme is ultimately proven to be legitimate.

The introduction of the A.P.N. regime has proved controversial, and the validity of a number of A.P.N.'s has been challenged by judicial review. To date, no judicial review challenge has been successful, and A.P.N.'s remain a powerful tool in H.M.R.C.'s crusade against tax avoidance.

Follower Notices

Alongside A.P.N.'s, Finance Act 2014 introduced the power for H.M.R.C. to issue Follower Notices ("F.N.'s"), which are aimed at marketed tax avoidance schemes where H.M.R.C. has already succeeded in the courts against one scheme user.

H.M.R.C. can issue an F.N. to a taxpayer when a final judicial ruling has been reached in relation to a tax avoidance scheme and H.M.R.C. considers that the principles in the ruling can be applied to deny the tax advantage being claimed by another taxpayer. A final judicial ruling is one that cannot be further appealed.

An F.N. may require the taxpayer to amend its return, if the return is still under examination, or enter into an agreement with H.M.R.C. to settle the dispute, where the taxpayer is appealing a tax assessment. The taxpayer is also required to give H.M.R.C. a notice stating that it has taken the necessary corrective action and notifying H.M.R.C. of the amount of additional tax that has become payable as a result. The taxpayer has 90 days in which to comply.

CORPORATE CRIMINAL OFFENSES OF FAILING TO PREVENT TAX EVASION

Background to the Offenses

In spring 2015, the U.K. government announced its intention to introduce a corporate offense for the failure to prevent tax evasion ("F.T.P"), whereby a business will be criminally liable if it fails to prevent its employees or any person associated with it from facilitating tax evasion.

The U.K. government has since held two public consultations. Two offenses are now being introduced as part of the Criminal Finances Act 2017, which received royal assent on April 27, 2017. The offenses are expected to come into force by the end of September 2017.

The Offenses

The legislation creates two new offenses. The first offense will apply to all businesses, wherever located, in respect to the facilitation of U.K. tax evasion. The second offense will apply to businesses with a U.K. connection in respect to the facilitation of non-U.K. tax evasion.

The F.T.P. offenses will apply to both companies and partnerships. The offenses will effectively make a business vicariously liable for the criminal acts of its employees and other persons "associated" with it, even if the senior management of the business was not involved or aware of what was going on.

There are two requirements for the new corporate offenses to apply:

- Criminal tax evasion (and not tax avoidance) must have taken place.
- A person or entity who is associated with the business must have criminally facilitated the tax evasion while performing services for that business.

"Associated persons" are employees, agents, and other persons who perform services for or on behalf of the business, such as contractors, suppliers, agents, and intermediaries.

For either of the offenses to apply, the employee or associated person must have criminally facilitated the tax evasion in its capacity as an employee or associated person providing services to the business. A company cannot be criminally liable for failing to prevent the facilitation of tax evasion if the facilitator was acting in a personal capacity.

Reasonable Prevention Procedures

A company will have a defense against criminal liability if it can prove that it had put in place reasonable prevention procedures to prevent the facilitation of tax evasion from taking place, or that it was not reasonable under the circumstances to expect there to be procedures in place. H.M.R.C. has published draft guidance on the offenses in which it explains that there are six guiding principles that underpin the defense of having reasonable prevention procedures:

- Risk assessment
- Proportionality of risk-based prevention procedures
- Top level commitment
- Due diligence
- Communication, including training
- Monitoring and review

A company will have to undertake a risk assessment to identify the risks of facilitation of tax evasion within the organization and the potential gaps in the existing control environment. The risk assessment should be documented so that it can provide an audit trail to support any policy decisions regarding the implementation of new procedures to reduce the risk of exposure to the F.T.P. offenses.

It is expected that following a risk assessment, most companies will have to introduce changes to ensure that they have robust procedures in place to prevent their employees, service providers, agents, suppliers, and customers from engaging in or facilitating tax evasion.

It will be important to secure top level commitment from a company's board and/or senior executives to mitigating the risks of exposure to the F.T.P. offenses and the need for the business to respond to such offenses. Companies will also need to ensure that sufficient training on tax evasion and the F.T.P. offenses is provided to all staff.

Territoriality

There are two separate offenses which apply where U.K. and non-U.K. tax respectively is evaded.

In relation to U.K. tax, the offense will apply to any company or partnership, wherever it is formed or operates.

Where non-U.K. tax is evaded, a business will have committed an offense if the facilitation involves (i) a U.K. company or partnership, (ii) any company or partnership with a place of business in the U.K., including a branch, or (iii) if any part of the facilitation takes place in the U.K. In addition, the foreign tax evasion and facilitation must amount to an offense in the local jurisdiction and involve conduct that a U.K. court would consider to be dishonest.

Distinguishing between Tax Avoidance and Tax Evasion

As noted above, the F.T.P. offenses will only apply when there has been fraudulent tax evasion. Fraudulent tax evasion is a crime and involves dishonest behavior. A person behaves dishonestly if he or she is aware of, or turns a "blind eye" to, his or her liability to pay tax but decide not to pay or declare it. Dishonest behavior may involve a person simply deciding not to declare money he or she makes. It may involve someone deliberately trying to hide the source of money, or even intentionally misrepresenting where money came from. In most countries, such dishonest tax evasion is considered illegal and therefore a crime.

Fraudulent tax evasion does not arise where a person makes a mistake or is careless. It also does not arise where a person actively seeks to avoid tax. A person's attempts to avoid tax may involve using complicated and artificial structures to exploit gaps in the rules of the tax system. Tax avoidance will usually involve arrangements to move assets from one place to another to secure a better tax treatment. Tax authorities may not agree that what has been done is legally effective and may challenge the taxpayer.

However, even if the tax authority successfully challenges a tax avoidance arrangement and the taxpayer is required to pay additional tax, the taxpayer will not have acted dishonestly if he held a reasonable belief that the tax was not due when he entered into the arrangement, even though he may have acknowledged that he may be proven wrong. Tax avoidance would only become evasion if the taxpayer dishonestly withheld or misrepresented information to try to make the planning appear effective when it is not in fact effective.

In relation to the F.T.P. offenses, the facilitator must also have a criminal intent and thus be an "accomplice." At its simplest, this will occur where the facilitator knows that he is helping another person to carry out fraud. Unwitting facilitation of tax evasion is not enough, nor would knowing facilitation of tax avoidance be enough.

F.A.T.C.A. – U.K. IMPLICATIONS

Background to Domestic Implementation

The U.S. government introduced the Foreign Account Tax Compliance Act as part of the Hiring Incentives to Restore Employment Act of 2010. F.A.T.C.A.'s primary function is to require financial institutions ("F.I.'s") outside the U.S. to report information on U.S. account holders to the I.R.S. The associated penalty for noncompliance is the "big stick" of a 30% U.S. withholding tax on certain income and principal payments to recalcitrant F.I.'s. The withholding tax applies to payments made by all persons, even those unrelated to the U.S. account in issue.

In the U.K., concerns were raised by the financial sector about the legal difficulties it would face in complying with F.A.T.C.A. reporting. Particularly, F.I.'s foresaw issues with respect to U.K. data protection laws and a subsequent negative impact on the competitiveness of U.K. financial institutions ("U.K.F.I.'s") as a result of withholding on U.S.-source payments.

In response, the U.K. government, along with the governments of France, Germany, Italy, and Spain, entered into discussions with the U.S. to address the implementation of F.A.T.C.A. These discussions resulted in the publication of a joint statement on February 8, 2012, which set out an agreement to explore an intergovernmental approach, and the Model Intergovernmental Agreement to Improve Tax Compliance to Implement F.A.T.C.A. on July 26, 2012.

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

Implementation of the I.G.A.

Section 222 of Finance Act 2013 empowers the Treasury to make regulations giving effect to the U.K.-U.S. I.G.A. Accordingly, the International Tax Compliance (United

States of America) Regulations 2013,[7] which give effect to the U.K.-U.S. I.G.A., came into force on September 1, 2013. Any expression that is defined in the U.K.-U.S. I.G.A. but not in the F.A.T.C.A. regulations published by the I.R.S. is treated as having the same definition as in the I.G.A.

Implications of the I.G.A.

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

- F.A.T.C.A. withholding will be avoided on payments made to and by U.K.F.I.'s, although the position on pass-thru payments remains outstanding;
- U.K.F.I.'s will report the relevant F.A.T.C.A. information to H.M.R.C., instead of the I.R.S., which is designed as a mechanism to avoid U.K. and E.U. data protection issues;
- U.K.F.I.'s F.A.T.C.A. reporting requirements 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 information from the U.S.

Therefore, for F.I.'s in the U.K., compliance with the U.S. Internal Revenue Code is intended to be superseded by equivalent obligations under the U.K. I.G.A. and its implementing legislation. The U.K. is responsible for enforcement of these obligations, in the first instance, in place of U.S. withholding. Failure to comply with the U.K. rules will result in the F.I. having to comply with the primary F.A.T.C.A. legislation in order to avoid withholding.

F.A.T.C.A. is particularly complex and its exact application can be uncertain. Most F.I.'s demand information regarding the U.S. or non-U.S. status of all customers or customers having accounts in excess of a certain amount. Where a U.K. holding company may be obliged to comply with F.A.T.C.A. as implemented in the U.K., information on the U.S. status of substantial holders must be provided to the U.K.F.I.

THE COMMON REPORTING STANDARD

Background

The Common Reporting Standard ("C.R.S.") was developed by the O.E.C.D. and provides a mechanism for countries to automatically exchange tax information. Specifically, the C.R.S. allows countries to obtain information from resident F.I.'s and automatically exchange that information with other countries.

The C.R.S. has been incorporated into U.K. law by the International Tax Compliance Regulations 2015. Reporting under the C.R.S. was introduced in 2016, with different countries adopting the regime at different times.

The U.K. is one of 56 jurisdictions that are "early adopters" of the C.R.S., undertaking

[7] SI 2013/1962.

to adopt reporting requirements from January 1, 2016. U.K.F.I.'s are required to report specified information to H.M.R.C. by May 31, 2017. H.M.R.C. will then exchange the relevant information with participating jurisdictions by September 30, 2017. The remaining countries will implement the C.R.S. in the coming years.

The aim of the C.R.S. is to crack down on the use of offshore jurisdictions to facilitate tax evasion. At this stage, notable exclusions to the list of participating countries include Pakistan, and the U.S. However, the reason for the U.S. exclusion is that F.A.T.C.A. already exists as a mechanism for identifying assets held offshore by U.S. citizens and U.S.-resident individuals.

Under the C.R.S., an entity that is an F.I. must carry out due diligence on its "account holders" – generally, persons who have debt or equity interests in that F.I. A wide variety of entities can constitute F.I.'s that are subject to reporting obligations, including banks, companies, and trusts. Entities that are not F.I.'s may be required to undertake certain due diligence procedures in support of self-certification obligations to F.I.'s.

F.I.'s report the collected information to the tax authority in their home jurisdiction. If any of those reported account holders are tax resident in another jurisdiction that has signed up to the C.R.S., the information covering the account holder will be forwarded to the relevant jurisdiction not later than nine months after the end of the calendar year on which the report is made.

The C.R.S. was modeled on and closely follows F.A.T.C.A., although the two regimes differ in certain respects. Following the introduction of F.A.T.C.A., the U.K. entered into a similar tax information reporting regime with its Crown Dependencies and Overseas Territories ("C.D.O.T.'s"), known as "U.K. F.A.T.C.A." U.K. F.A.T.C.A. is being phased out and, ultimately, will be replaced by the C.R.S.

Given that the U.S. has not committed to exchange information under the C.R.S., F.A.T.C.A. arrangements under the U.K.-U.S. I.G.A will remain in place. Ultimately, F.A.T.C.A. and the C.R.S. will run parallel to each other, with F.A.T.C.A. remaining in place for U.S. citizens (including green card holders) and U.S. tax residents, and the C.R.S. applying for many other jurisdictions.

Enforcement of the C.R.S.

Enforcement of the C.R.S. will be implemented by way of a penalty system. Different jurisdictions may operate different penalty systems for noncompliance.

In the U.K., there are a series of penalties that may apply to noncompliant F.I.'s. There is an automatic penalty of £300 for failing to comply with the C.R.S. and an additional £60 per day penalty if the failure to comply continues after a warning is received from H.M.R.C. There is also an additional flat-rate penalty of £3,000 if H.M.R.C. determines that there are errors on the C.R.S. return itself.

In addition to these specific C.R.S.-related penalties, H.M.R.C. may also levy tax-related penalties under the existing tax penalty regimes. There is a specific penalty regime for offshore tax evasion, which was recently strengthened.

U.K. taxpayers who may be liable to tax-related penalties under the C.R.S. should be aware that the percentage penalty can be increased, depending on the territory and the severity of the offence, to up to twice the original tax cost if there is an offshore element involved.

BELGIUM

Author
Werner Heyvaert
Jones Day
Brussels, Belgium

The author would like to acknowledge the contributions of Valérie Oyen, also of Jones Day, in the preparation of this section.

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 corporation income tax or a Belgian branch of a foreign company is eligible, under appropriate circumstances, for benefits of the Belgian participation exemption, which provides a favorable tax regime for dividends and capital gains from the disposition of shares of stock in subsidiary corporations. However, since the regulations were amended in 2007,[1] the Private P.R.I.C.A.F. also offers certain opportunities as an investment vehicle for collective investments 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.

CORPORATION INCOME TAX

General Regime

A Belgian company is subject to corporation income tax on its worldwide profit. For corporation income tax purposes, a company's taxable profit is determined based on its commercial accounts prepared as standalone Belgian G.A.A.P. accounts. Statutory accounts prepared using I.A.S. or I.F.R.S. cannot be utilized for Belgian corporate tax purposes. The general corporation income tax rate in Belgium amounts to 33.99%, which includes a 3% austerity surcharge.

Participation Exemption – General

Under the participation exemption, qualifying dividends received by a Belgian company are eligible for a 95% deduction. 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 ("S.M.E."),[2] or taxation at a special rate of 0.412% for other corporate recipients. If the shares are held for less than one year, capital gains are taxed at a special flat rate of 25.75%.

---

1 Royal Decree of May 23, 2007.

2 The notion of a "small- or medium-sized enterprise" is defined in the Belgian Company Code and the criteria are adjusted from time to time. At the time of this writing, a company is required to satisfy at least two of the following tests for a term of more than two years in order to qualify as an S.M.E.: (i) average number of employees ≤ 50; (ii) turnover (*i.e.*, sales) ≤ €9,000,000 (per annum); and (iii) balance-sheet total ≤ €4,500,000. If the taxpayer is part of a consolidated group, the thresholds are tested on a consolidated basis.

Dividends Received Deduction

The full amount of all dividends received – net of foreign withholding tax – is first included with all other taxable income items of the Belgian company. Subsequently, 95% of qualifying dividends are deducted, but only to the extent that the initial computation results in a positive balance.[3] In principle, the remaining 5% of dividends received will be part of the taxable income of the Belgian company. If the net result of the Belgian company's other activities is negative in the current year, none or only part of the qualifying dividends can be deducted. Prior to the *Cobelfret* case discussed below, any negative result of the Belgian company derived from other activities was wholly or partially "absorbed" by dividends qualifying for the participation exemption. The loss was used to offset dividends before the computation of the dividends received deduction. This reduced the net operating losses eligible for carryover to subsequent tax years. The "unused" portion of the dividends received deduction was permanently lost. The situation is now more nuanced.

The European Court of Justice delivered a ruling in *Cobelfret v. Belgium* (Case C-138/07) on February 12, 2009. In line with the Advocate General's opinion of May 2008, the E.C.J. concluded that Belgium failed to refrain from taxing qualifying dividends, as is required under Article 4(1) of the E.U. Parent-Subsidiary Directive ("P.S.D."). Two other cases were decided by "reasoned order" of the E.C.J. on June 4, 2009.[4] These cases dealt with E.U.-source dividends, Belgian domestic dividends, and dividends from countries outside of Europe. The E.C.J. asked the national courts to decide whether discrimination existed in the treatment of nonresident taxpayers when compared with resident taxpayers. This triggered an amendment to the statute by the Law of December 21, 2009, effective January 1, 2010. The net effect is that the unused portions of the dividends received deduction can be carried forward for use in future tax years only if, at the time that the dividend is declared, the dividend-distributing company is established

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

In addition, Belgium disallows the dividends received deduction for dividends received by a Belgian company to the extent that its taxable income (*i.e.*, profit) consists of certain nondeductible expenses. However, according to Article 205, §§2 and 3 I.T.C., the disallowance does not apply to dividends stemming from qualifying

---

[3] At the time of writing, the Belgian government is proposing an increase of the dividends received deduction to 100%, as in the Netherlands and Luxembourg.

[4] *Belgische Staat v. KBC Bank NV*, Joined Cases C-439/07 & C-499/07, [2009] E.C.R. I-04409.

subsidiaries established in E.U. Member States. In a circular letter dated 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 allowance for qualifying E.E.A.-source dividends is embodied in the statute.

"95% of qualifying dividends are deducted. . . . In principle, the remaining 5% of dividends received will be part of the taxable income of the Belgian company."

Where the facts of a particular case involving dividends from a company meet none of the foregoing criteria, the law remains unfavorable for taxpayers. According to a ruling of February 1, 2011 from the Tribunal of First Instance in Brussels, the rule that excess dividends cannot be carried over if they stem from subsidiaries in non-E.E.A. countries (with which Belgium does not have a bilateral tax treaty in force containing an equal treatment provision) does not run afoul of the Belgian constitutional non-discrimination rule. In this case, the tax administration allowed a taxpayer to carry over excess dividends from a Japanese subsidiary of a Belgian holding company because there is an equal treatment provision in Article 23(2)(a) of the Belgian-Japanese bilateral tax treaty. However, the tax administration refused to allow the carryover of Taiwanese and South Korean dividends, because the treaties with those jurisdictions do not contain an equal treatment clause. Before the Brussels Tribunal, the taxpayer claimed that the aforementioned distinction ran afoul of the Belgian nondiscrimination rule of Articles 10 *juncto* 172 of the Belgian Constitution. However, the Tribunal sided with the tax administration, concluding that the distinction between an E.E.A.-source dividend and a "third country dividend" is based upon an objective criterion, and for that reason, is permissible.

In a similar case decided on October 10, 2012, the Belgian Constitutional Court confirmed that the carryforward or denial of a dividends received deduction for excess dividends from companies organized in third countries not having double tax treaties with equal treatment clauses does not constitute a violation of the constitutional nondiscrimination principle.

Minimum Participation Value

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

Minimum Holding Period

A minimum holding period of one uninterrupted year is required in order for the dividends received deduction to apply. The minimum holding period of one uninterrupted year may occur partly before and partly after the dividend distribution. Moreover, the Belgian holding company is required to have full legal title to the shares. A right of *usufruct*[5] over the income from the shares does not suffice. In general, the minimum holding period should cover shares representing the minimum percentage or the minimum price or value required to enjoy the participation benefit. This means that dividends stemming from shares acquired less than one year before the dividend distribution of the dividend should qualify for the dividends received deduction provided the Belgian holding company has held on to 10% or €2.5 million worth of shares for one uninterrupted year, as defined.

---

[5] A *usufruct* right is a form of economic right to dividends generated by shares. The right exists for a limited period of time and is separate from a capital interest.

Subject to Comparable Tax

To qualify for the dividends received deduction, the subsidiary paying the dividend must meet a subject-to-tax requirement. If the subject-to-tax requirement is not met, the dividends are not exempt in the hands of the corporate shareholder. Consequently, the dividends received deduction is not available for dividends distributed by a company that is subject to neither Belgian corporation income tax nor to a foreign tax similar to the Belgian corporation income tax. A foreign tax is not considered similar if it is substantially more advantageous than Belgian corporation income tax. Typically, this means that the nominal rate of tax or the effective rate is below 15%.

The Royal Decree implementing the Belgian Income Tax Code contains a list of jurisdictions that fail the normal-tax-regime test. As of June 1, 2016, this list includes the following jurisdictions:

Abu Dhabi	Ajman	Andorra
Bosnia & Herzegovina	Dubai	East Timor
Gibraltar	Guernsey	Isle of Man
Jersey	Kosovo	Kuwait
Kyrgyzstan	Liechtenstein	Macau
Macedonia	Maldives	Marshall Islands
Micronesia	Monaco	Montenegro
Oman	Paraguay	Qatar
Ras al Khaimah	Serbia	Sharjah
Turkmenistan	Umm al Qaiwain	Uzbekistan

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

The tax regimes of all E.U. jurisdictions are deemed to be equivalent to the Belgian corporation income tax regime, even if the tax rate would be below 15%. Examples of countries benefitting from this rule are Ireland and Cyprus.

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 where the entity enjoys a tax regime that deviates from the normal tax regime in its country of residence.

A finance company is a company for which 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) is its sole or principal activity. For these purposes, a group is defined under the standard previously applicable to the Belgian Coordination Center Regime. It includes affiliated companies under a unique management due to direct or indirect participation of members. A group is presumed to exist when a company maintains a 20% shareholding in another company or owns 20% of voting rights in another company.

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 whose purpose is the collective investment of capital funds (*e.g.*, S.I.C.A.V.’s, S.I.C.A.F.’s, and comparable entities).

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

Offshore Activity

The dividends received deduction is not available for dividends distributed by a company when the non-dividend income of that company originates in a third country and such income is subject to a separate tax regime that provides more favorable results than the normal tax regime.

Certain Foreign Branch Income

The dividends received deduction is not available when the dividends are distributed by a company that realizes profits through a foreign branch that is subject to a tax assessment regime substantially more advantageous than the tax that would apply to such profits had the operations been conducted in Belgium. This disallowance rule is subject to an exception. The dividends received deduction will be allowed for dividends distributed by Belgian companies with foreign branches or companies established in certain treaty jurisdictions that operate through a branch in a third country.

Dividends stemming from non-Belgian branch profits qualify for the dividends received deduction to the extent that either the branch profits are subject to a 15% foreign income tax or the branch is located in another E.U. jurisdiction.

Intermediate Companies

The dividends received deduction is not available for dividends distributed by an intermediate 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 intermediate 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 cleanse tainted dividends by washing them through an intermediary located in an acceptable jurisdiction.

As a safe harbor, 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 such as U.S. limited liability companies (“L.L.C.’s”), the Belgian Ruling Committee issued several favorable rulings. In most instances, the Ruling Committee confirmed that, for Belgian tax purposes, one can look through a foreign hybrid entity to allow the participation exemption as if the underlying participations had been held directly by the Belgian holding company.

Purchased Dividend

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

According to the Belgian Commission for Accounting Standards ("C.A.S."), purchased dividends should not go through the Acquirer's profit and loss account, but should reduce the book value of the Target-shareholding in the balance sheet of the Acquirer.[6] For this purpose, book value should equal the purchase price. As a result, the purchased dividend is not included in the Acquirer's financial income. Consequently, it does not need to invoke the dividends received deduction. The Acquirer is not subject to tax on the nondeductible portion of 5% of the purchased dividend.

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

Other Aspects

Interest and other expenses relating to the acquisition or the management of shares in, or capital contributions to, a Belgian or foreign company remain fully deductible in principle, subject to the relevant conditions of Belgian tax law. Finally, the participation exemption applies to payments received in connection to 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 hypothetical 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,[7] resulting in an N.I.D. rate of 2.74% (3.24% for S.M.E.'s). For fiscal year 2018, the N.I.D. rate is equal to 0.237% (0.737% for S.M.E.'s).

As an austerity measure, unused portions of the N.I.D. can no longer be carried

---

6 Advice No. 151/2 of March 1995.

7 In the summer of 2015, the Belgian government introduced limitations to the N.I.D. for banks and insurance companies by excluding part of the increase of the prudential capital under Basel III (banks) and Solvency II (insurance companies) from the deduction.

over to subsequent tax years.[8] To curb perceived abuses, the amount of equity that serves as the basis for computation of the N.I.D. is adjusted by deducting, *inter alia*, the commercial book value of participations that qualify for the participation exemption.[9]

In addition, Belgium's "patent income deduction" ("P.I.D.") was abolished as of July 1, 2016, subject to grandfathering, according to which the P.I.D. may still be applied until June 30, 2021 for qualifying patents received or applications filed before July 1, 2016. A new "innovation income deduction" ("I.I.D.") has been introduced, based on the "modified nexus approach" recommended by the O.E.C.D. in B.E.P.S. Action Item 5. The new regime is effective as of July 1, 2016. Under the I.I.D. regime, qualifying intellectual property income is eligible for a tax deduction of up to 85%, resulting in an effective tax rate of 5.10% (*i.e.*, the regular rate of 33.99% applied to the remaining 15%). One of the benefits of the I.I.D over the phased out P.I.D. regime is that income from copyrighted software is also eligible for the 85% deduction.

Ruling Practice

The Belgian tax administration must, upon the taxpayer's request, issue an advance tax ruling on items such as the availability of the dividends received deduction and whether any 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 nonqualifying in the official tax haven list (see **Subject to Comparable Tax**). In principle, the tax authorities must issue their ruling within three months of the receipt of a complete and exhaustive ruling application.

Capital Gains Exemption

Under the participation exemption, net capital gains realized by a Belgian-resident company or by a Belgian branch of a foreign company on the disposition of shares in a Belgian or a foreign subsidiary are either taxed at a special rate of 0.412%, or if the recipient is a corporation qualifying as an S.M.E., fully exempt from Belgian corporation income tax. Favorable treatment applies only when dividends previously paid on the shares sold qualified for the dividends received deduction. The test for qualification is discussed above under **Minimum Holding Period** through **Intermediate Companies**.

An anti-abuse provision may be applicable to the exemption for gains. It applies where the foreign subsidiary directly or indirectly derived dividends from one or more

---

8 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.

9 The initial rule that excluded the net assets of a Belgian corporation held through a branch ("permanent establishment") located in a treaty country and real estate located in a treaty country from the basis for computation of the N.I.D. was repealed following the *Argenta Spaarbank* case of the E.C.J. (Case No. C-350/11 of July 4, 2013). The Belgian statute was amended on December 21, 2013 and the Belgian tax authorities commented on the new rules in a circular letter dated May 16, 2014. Note that the Belgian tax authorities and the Belgian courts have a different opinion regarding the application of the new rules. The tax authorities have applied the amended N.I.D. calculation method for all past years. The courts do not agree with this approach and state that the new rules should be applied from tax assessment year 2014 onwards.

companies not meeting the anti-abuse requirements for the dividends received deduction. The view of the Belgian tax authorities is that the entire capital gain on the disposition of the shares of the subsidiary is taxable.[10]

If the exemption applies, only the net amount of eligible capital gains is exempt from tax. Consequently, costs and expenses incurred by the corporate shareholder in connection to the realization of the exempt gain must be allocated to that gain. As a result, these expenses do not reduce ordinarily taxed income and no benefit is received.

No Minimum Ownership; One Year Holding Period Requirement

The minimum participation requirements that exist for dividends – ownership of 10% of the capital or acquisition value of not less than €2.5 million – do not apply for capital gains.[11] However, the same one-year holding period requirement that exists for the dividends received deduction (see **Minimum Holding Period** above) applies for the exemption of capital gains on shares pursuant to the Program Law of March 29, 2012. The exemption applies only to the extent that the capital gains realized on the shares exceed the tax book value of these shares.

In the past, uncertainty existed regarding the participation exemption where the shares were acquired by the Belgian holding company at a price or value that was far below the actual value at the time of acquisition. The position of the Belgian tax authorities was that the difference between the low acquisition value and the high actual value should be booked as an underestimation of assets and taxed as regular income of the holding company. The income accrued in the year of acquisition and should be taxed retroactively at the full corporation income tax rate of 33.99%.

"Going forward, the full gain based on the low purchase price is exempt."

This position was successfully challenged in the *Gimle* case in a preliminary ruling from the E.C.J. that was settled definitively by the Court of Cassation.[12] Going forward, the full gain based on the low purchase price is exempt.

The capital gains exemption is granted by a direct elimination of the net gain from taxable income. Consequently, loss utilization is not adversely affected. Losses derived from other activities of the Belgian holding company are not allocated to the exempt gain.

Effective for fiscal years ending on or after December 31, 2013,[13] capital gains are not fully exempt from corporation tax if the recipient corporate taxpayer does not qualify as an S.M.E. (see **Participation Exemption – General**). Capital gains are subject to separate taxation at a combined rate of 0.412%, regardless of the availability of N.O.L.'s or other tax attributes or tax assets.[14] The rate of 0.4% is increased by the austerity tax of 3%, bringing the aggregate effective rate to 0.412% of the capital gains. In addition, capital gains on shares that fail the one-year holding test are taxed at a special rate of 25.75%, consisting of the income tax of 25%

[10] This is contested.

[11] At the time of writing, the Belgian government is preparing legislation that would apply the same minimum ownership treshhold for the exemption of capital gains that exists for the dividends received deduction.

[12] Court of Cassation, May 16, 2014, F.10.0092.F.

[13] 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.

[14] Program Law of December 27, 2012 (*Belgian State Gazette* December 31, 2012).

and the austerity tax of 3%).

Special rules apply to financial institutions. The one-year holding requirement does not apply to qualifying financial institutions for shares pertaining to their trading portfolio. Those gains continue to benefit from a 100% exemption from corporation 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. However, 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 the 0.412% tax if the one-year holding requirement is satisfied, assuming the taxpayer is not an S.M.E.

Options

If a Belgian company purchases stock below fair market value pursuant to the exercise of a call option or a warrant, any subsequent gains realized upon the disposition of the shares of stock qualify in principle as capital gains subject to tax at a rate of 0.412%. The minimum rate 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 be subject to the standard corporation income tax rate.

Unrealized Gains

Unrealized capital gains are not taxable if the capital gains are not reported in the accounts. Even if reported, said unrealized gain is not taxable if it is booked in a non-distributable reserve account. Upon later realization of the gain, the non-distributable reserve account disappears without triggering corporation income tax.

Capital Losses

Capital losses on the disposition of shares are not tax deductible. However, the loss incurred in connection to the liquidation of a subsidiary company remains deductible up to the amount of paid-up share capital. Capital losses do not reduce the tax base subject to the 0.412% tax on capital gains. (See **No Minimum Ownership; One Year Holding Period Requirement** above.)

Deductible Expenses

Interest paid by a Belgian company is generally tax deductible, provided the general arm's length criteria and specific debt-to-equity rules are met. However, several exceptions exist.

Pursuant to the Law of June 22, 2005, only the net amount of capital gains is exempt, *i.e.*, the gross capital gains minus costs and expenses incurred in connection to the realization of the gain (*e.g.*, brokerage fees, stamp duties, etc.). In a circular letter of April 6, 2006, the Belgian tax authorities commented on the limitation of the exempt amount of the capital gains on shares. This circular letter contains, *inter alia*, a list of costs and expenses that must be deducted from the gross amount of the sales proceeds of the shares in order to compute the net amount of the capital gains that is eligible for exemption from corporation income tax. These include the following:

- Costs of publicity (*e.g.*, advertisements, etc.)
- Fees of a civil law notary

- Brokerage fees
- Financial costs (*i.e.*, foreign exchange losses)
- Financial discounts
- Stamp taxes
- Export levies
- Insurance or other coverage costs
- Commission fees
- Advisory fees
- Consultancy costs
- Transportation costs
- Technical audit and inspection costs, which may include costs for vendor due diligence
- Fees of experts, appraisers, etc.

The rationale behind this rule is to curtail the use of a double dip. The gross amount of the sales proceeds of the shares was used to determine the exempt capital gains on shares while all costs and expenses incurred with the sale of the shares were deductible against ordinary income.

Belgium has a thin capitalization rule (Article 198, 11º, I.T.C.) providing for a 5:1 debt-to-equity ratio. The ratio applies to test the deduction for interest paid to low-tax and tax haven lenders and to companies of the same group. Because the government did not want this new thin capitalization rule to apply immediately to Belgian treasury centers, qualifying treasury centers are allowed to offset interest owed to group companies against interest received from group companies. Only the excess amount of net interest owed to group companies is disallowed if the 5:1 debt-equity ratio is exceeded.

WITHHOLDING TAX ON DISTRIBUTIONS

To Belgium

Dividends distributed by a non-Belgian company to a Belgian company may be subject to a dividend withholding tax at the rate in effect in the country of residence of the company paying the dividend. In most situations, this rate is reduced or eliminated by a bilateral tax treaty or the P.S.D. With the exception of investment companies, Belgium does not grant a tax credit for foreign withholding tax imposed on dividends.

From Belgium

In principle, all dividends distributed by Belgian companies to resident and nonresident shareholders are subject to a withholding tax of 30%. Under specific circumstances, reduced rates are available.

A full exemption of Belgian withholding tax applies on the distribution of dividends to a parent company established within the E.U. (including Belgium) or in a country with which Belgium has concluded a bilateral income tax treaty containing an exchange of information provision. In the latter instance, the shareholder must hold at least 10% of the capital of the Belgian-resident company.[15] Once a qualifying parent company holds a qualifying participation, all additional acquired shares also qualify, even if the one-year holding period is not met with respect to the additional shares.

Denkavit and *Tate & Lyle Investments*

Following the ruling from the E.C.J. in the *Denkavit* case, Belgium abandoned the condition that the parent must have held a participation of at least 10% for an uninterrupted period of at least one year preceding the distribution of the dividend. Therefore, the parent may hold the 10% participation for one entire year, which may occur partly before and partly after the dividend distribution. If the one-year hurdle is not fully met at the time the dividend is paid, the Belgian distributing company is allowed to pay out the net dividend only (*i.e.*, the gross dividend minus an amount equal to the dividend withholding tax that would apply if the one-year holding period is not respected). If the latter occurs, the amount of withholding tax becomes due, increased by interest for late payment. Otherwise, the undistributed portion of the dividend can be distributed freely once the one-year holding requirement is met.

Unlike the participation exemption, the exemption from dividend withholding tax is subject to the conditions mentioned in the P.S.D. with respect to the legal form, E.U. tax residence, and the parent company's compliance with a subject-to-tax requirement. As a result of the amendment of the P.S.D., several types of entities that were not eligible for the withholding tax exemption now qualify, 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 corporation income tax.

To comply with the E.C.J. decision in *Tate & Lyle Investments* (Case C-384/11), a 1.6995% withholding tax was introduced for Belgian-source dividends paid to qualifying foreign companies that hold participations in Belgian companies of less than 10%. Effective as of December 28, 2015, the tax applies to companies established in E.E.A. Member States and treaty countries if a bilateral tax treaty provides for the exchange of information. The withholding tax is intended to subject the foreign parent to a tax burden equivalent to that which would be imposed upon a domestic parent that receives Belgian-source dividends eligible for the dividends received deduction (*i.e.*, 33.99% x 5% = 1.6995%).

Liquidation/Redemption Distributions

Until recently, the dividend withholding tax rate was 10% in the case of the liquidation of a Belgian company. This reduced rate has been abandoned, effective October 1, 2014. A transitional regime encouraged companies to strengthen their capital by converting their reserves into capital before or during the accounting year ending at the latest on September 30, 2014, at a rate of 10%. By doing so, the 30%

---

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

withholding tax, due upon liquidation, could be limited to the 10% withholding tax, due upon conversion.

The transitional 10% withholding tax regime for liquidation distributions has become permanent for S.M.E.'s. As of tax year 2015, S.M.E.'s are allowed to allocate part or all of their accounting profit to a liquidation reserve. The reserve must be booked in an unavailable equity account that is subject to a separate 10% tax. No additional withholding tax will be due provided that this reserve is maintained until liquidation and hence distributed as a liquidation distribution.

Distributions to shareholders made pursuant to a resolution by the company to redeem or buy back its own stock from shareholders have been subject to a preferential withholding tax regime for many years. However, the preferential regime was abandoned, effective January 1, 2013. The withholding tax rate is now set at 30% if dividends result from a redemption of shares or a share buy-back.

"The transitional 10% withholding tax regime for liquidation distributions has become permanent for S.M.E.'s. . . . No additional withholding tax will be due provided that this reserve is maintained until liquidation."

Distributions pursuant to liquidations and redemptions may be eligible for rate reductions or exemptions from withholding tax under a bilateral income tax treaty concluded by Belgium, the P.S.D., or the unilateral extension of the P.S.D. withholding tax exemption discussed above.

Any repayment of share capital or share premium to the shareholders is exempt from dividend withholding tax, provided that the reimbursed capital consists of paid-up fiscal capital, does not consist of reserves, and the reduction of capital is executed in accordance with the Belgian Company Code.

Refund of Withholding Tax for Nonresident Investment Funds

Following the E.C.J. ruling of October 25, 2012 (Case No. C-378/11), the Belgian tax authorities issued a circular letter[16] regarding the conditions and formalities for nonresident investment funds to obtain a refund of Belgian withholding tax imposed on dividends and interest. As a result, if a Belgian-resident investment fund would be allowed to credit Belgian withholding tax and obtain a refund, the nonresident investment fund is entitled to a refund. The circular letter limits requests for refunds from prior years to dividends paid or awarded between January 1, 2007 and December 31, 2012 to investments funds covered by E.U. Directive 85/611/E.E.C. of December 20, 1985, or Directive 2009/65/E.C. These directives were adopted into Belgian law as part of the Law of August 3, 2012. Only the amount of withholding tax that cannot effectively be credited or reimbursed to the investment fund in its state of residence is eligible for a refund in Belgium.

Foreign investment funds have a five-year period to claim the refund after the Belgian withholding tax was initially paid. The period is ten years if the withholding tax was paid prior to January 1, 2011. The circular letter does not mention whether interest will be allowed, but authoritative legal doctrine and case law from the Constitutional Court support the view that the refund of withholding tax is eligible for interest payment.

Fairness Tax

Effective for book years ending on or after December 31, 2013, Belgian companies making profit distributions must take into account a new tax, called the Fairness

---

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

Tax.[17] Belgian companies and Belgian branches of foreign companies making profit distributions out of income that has not, effectively, been subject to corporation income tax may under certain conditions be subject to a standalone tax of 5.15% (5% plus an austerity surcharge of 3%). The Fairness Tax is not a withholding tax, but a tax on the distributing company in many respects akin to the Alternative Minimum Tax in the U.S. The Fairness Tax is imposed when corporation income tax is eliminated by the N.I.D. or carryover losses, but the company pays a dividend nonetheless.

The legal validity of the Fairness Tax and its compliance with E.U. law are open to question. A request to annul the Fairness Tax has been filed with the Belgian Constitutional Court.[18] The Belgian Constitutional Court has requested a preliminary ruling from the E.C.J. on the compatibility of the Fairness Tax with E.U. law.

As a result, the application of the Fairness Tax will remain subject to uncertainty until a preliminary ruling is delivered by the E.C.J. In practice, the E.C.J. often follows the judgment of the European Commission.

On November 17, 2016, the Advocate General issued its opinion. The tax does not violate the freedom of establishment and is not a prohibited withholding tax under the P.S.D. The Fairness Tax, however, partially violates the P.S.D. to the extent that 5% of received dividends are taxed in the year of receipt – pursuant to the dividends received deduction – and that such dividends are additionally subject to the Fairness Tax in the year of redistribution.

The E.C.J.'s decision of May 17, 2017 follows and adds nuance to this opinion. According to the E.C.J., the Belgian Constitutional Court must assess whether a Belgian permanent establishment is treated less favorably than a Belgian corporation when calculating the taxable base subject to the Fairness Tax. To the extent such discrimination exists, the Fairness Tax would also violate the E.U. principle of freedom of establishment.

The Belgian Constitutional Court now must issue its final decision, taking into account the E.C.J.'s decision. At this stage, it is unknown when the decision will be issued and what the exact impact will be for the taxpayer. The Belgian government will need to reassess the Fairness Tax.

WITHHOLDING TAX ON OUTBOUND INTEREST PAYMENTS

Interest paid by any Belgian company is, in principle, subject to an interest withholding tax of 30%. This domestic rate can often be reduced by bilateral tax treaties, the E.U. Interest and Royalty Directive, and several domestic exemptions that have been implemented in Belgium.

CAPITAL DUTY

Pursuant to the Law of June 23, 2005, the rate of capital tax is set at 0%[19] for all contributions to share capital occurring on or after January 1, 2006.

---

17 Inserted in the Belgian Tax Code by the Law of July 30, 2013.

18 Constitutional Court case no. 11/2015 dated January 28, 2015 (No. 5828).

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

V.A.T.

On the basis of E.C.J. case law, a distinction is made between "active" and "passive" holding companies.[20] A passive holding company has no economic activity that gives entitlement to credit input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or participations. An active holding company, however, is involved in its subsidiaries' management. To the extent that its activities are neither exempt nor outside the scope of V.A.T., an active holding company can credit input V.A.T. against output V.A.T.

Based on a response in 2010 from the Belgian Minister of Finance on a Parliamentary Question,[21] even V.A.T. incurred in connection to a sale of shares may, under appropriate circumstances, be creditable and refundable. This insight is derived from the E.C.J.'s ruling of October 29, 2009 on Case C-29/08, *Skatteverket v. AB SKF*. First, one should determine whether there is in principle a direct relationship between a "previous" transaction (*e.g.*, an input transaction on which input V.A.T. is chargeable) and a "subsequent" transaction (*e.g.*, an output transaction that is subject to output V.A.T.). If a relationship exists, the input V.A.T. can be credited. However, if there is a direct relationship between an input transaction and an output transaction that is either exempt from V.A.T. or outside the scope of V.A.T., the input V.A.T. is not creditable (as was the situation in E.C.J. Case C-4/94 of April 6, 1995, *BLP Group*). If no direct relationship exists between the input transaction and any output transaction, the input V.A.T. may still be creditable when the cost for the input services is part of the general expenses of the taxpayer and is included in the price charged by the taxpayer for goods delivered or services rendered.

This principle was formulated in the *Skatteverket v. SKF* case – the Belgian tax administration accepted that input V.A.T. could be creditable in the event of an issuance of new shares or the purchase of shares. However, V.A.T. credit is not available if the cost of the input transaction on which V.A.T. was charged is included into the sales price of the shares, which is either exempt or out of the scope.

PRIVATE P.R.I.C.A.F.

Private P.R.I.C.A.F.'s are unlisted collective investment undertakings aimed at investing in unlisted 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, although immaterial 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 unlisted companies: shares, bonds, and debt instruments of all kinds; securities issued by other undertakings for collective investment; and derivative financial

---

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

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

instruments such as subscription rights and options. Other investments are either partially and/or temporarily authorized or prohibited.

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

Dividends distributed by a Private P.R.I.C.A.F. are in principle subject to a 30% withholding tax. However, distributions stemming from capital gains realized on shares held by the Private P.R.I.C.A.F. are exempt from withholding tax. Also exempt are redemption premiums and liquidation gains. Under specified conditions, the dividends distributed by the Private P.R.I.C.A.F. may benefit from the dividends received deduction regime.

B.E.P.S. IN BELGIUM

In General

In some areas, Belgium has begun to implement measures (*e.g.*, Action Item 5 regarding the I.I.D. and Action Items 8 through 10 and 13 regarding transfer pricing) that are a reaction to the O.E.C.D. initiative to combat base erosion and profit shifting (the "B.E.P.S. Project"). The Minister of Finance has indeed announced that the government is supportive of the project and that it intends to take legislative action which is in line with B.E.P.S. Project recommendations. Nonetheless, the Belgian government prefers to engage in coordinated action regarding measures to combat B.E.P.S. and will await guidance from the European Commission before taking legislative action regarding certain Action Items.

On June 20, 2016, the E.U.'s Economic and Financial Affairs Council ("E.C.O.F.I.N.") reached agreement on the draft Anti-Tax Avoidance Directive ("A.T.A.D."), the aim of which is to harmonize several B.E.P.S. measures at the E.U. level, such as Action Item 2 (hybrid mismatches), Action Item 3 (C.F.C. rules), and Action Item 4 (the interest limitation rule). Most measures must be implemented in Belgium by December 31, 2018 at the latest.

Measures Implemented in Line with B.E.P.S.

B.E.P.S. Action 2: Hybrid Mismatches

The Belgian government is currently working on draft legislation to implement the E.U. anti-hybrid mismatch rule provided for in the A.T.A.D. Pursuant to the draft, dividends derived from a subsidiary will be excluded from the dividends received deduction to the extent that the subsidiary has deducted, or can deduct, this income from its profit. In addition, the Belgian implementation of the general anti-abuse rule, which is also part of the A.T.A.D., will be addressed. Dividends received by the parent may not be deducted if the "legal act" is determined to be abusive. In such cases, the exemption from dividend withholding tax would also be denied.

B.E.P.S. Action 3: C.F.C. Rules

Belgium may not have C.F.C. legislation in place yet, but it has extensive anti-abuse rules with similar effects as C.F.C. rules. There is, for example, Article 344 §2 of the

I.T.C., which tackles asset transfers to tax havens. Article 54 of the I.T.C. denies the deduction of interest payments to low-taxed entities and Article 307 of the I.T.C. imposes a reporting obligation on taxpayers making payments to offshore entities.

Recently, Belgium adopted legislation introducing a look-through tax (sometimes referred to as a "Cayman tax") for income derived by individual taxpayers from the use of foreign vehicles such as trusts or foundations. These "juridical arrangements" must be reported on the individual's personal income tax return as of tax year 2014, but the income in the trust or foundation often is not taxable in Belgium. Taxation will be imposed by considering these trusts and foundations as tax transparent, so that the income would be taxable directly in the hands of the resident individual who is the beneficiary.

"These reporting requirements should enhance transparency regarding transfer pricing policies applied within multinational groups."

In addition, the A.T.A.D. contains a C.F.C. component, which is intended to deter profit shifting to low- or no-tax jurisdictions. These C.F.C. rules are mandatory in all E.U. Member States. The Commission aims to discourage income shifting by re-attributing income from passive, lightly-taxed controlled foreign subsidiaries to the E.U. parent companies. Belgium must implement this rule by December 31, 2018 at the latest.

B.E.P.S. Action 4: Excessive Interest Deductions

Similar to most other countries, Belgium already has various rules limiting excessive interest deductions. The most well-known rule is the thin capitalization rule, which imposes a debt-to-equity ratio of 5:1. It is not clear whether the Belgian thin capitalization rule should be tightened and expanded to apply to interest on all debt owed by a domestic corporation.

In any event, Belgium must implement the A.T.A.D., providing an interest limitation rule to discourage companies from creating artificial debt arrangements designed to minimize tax. Interest is deductible only up to a certain amount: the greater of 30% of an entity's tax-adjusted earnings before interest, taxes, depreciation, and amortization or €3,000,000. The Belgian government is currently drafting legislation to implement this rule. It has been speculated that loans entered into prior to June 17, 2016 will be grandfathered (*i.e.*, interest on such loans will not be subject to the limitation based on 30% of E.B.I.T.D.A.) and that financial institutions will be carved out of the interest limitation rule altogether.

B.E.P.S. Actions 8, 9, 10, and 13: Transfer Pricing

Belgium has transfer pricing rules in place to avoid profit shifting, and in recent years the number of transfer pricing audits has increased remarkably. However, up until recently, Belgium did not have any specific statutory transfer pricing documentation requirements in place. It is of course advisable to have sufficient documentation available, as a lack of documentation may result in a thorough transfer pricing audit.

Recently, the Belgian Minister of Finance stated that, as part of the B.E.P.S. Project, the Belgian government envisages introducing formal transfer pricing documentation requirements which would contribute to more transparency and more efficient tax audits. He also announced that the specialized transfer pricing investigation team will continue to conduct transfer pricing audits in Belgium.

On July 1, 2016, the Belgian Parliament passed legislation to introduce specific transfer pricing documentation requirements based on B.E.P.S. Action 13. This means that, going forward, the O.E.C.D.'s recommended three-tiered approach to transfer pricing documentation will be mandatory. These reporting requirements should enhance transparency regarding transfer pricing policies applied within multinational groups. As a result, a Belgian entity forming part of an international group must compile a Master File and a Local File if certain criteria are met. In addition, if the ultimate parent of a multinational group is a Belgian company, and if it has gross consolidated revenue of at least €750 million, it will also have to file a country-by-country report with the Belgian tax authorities within 12 months after the closing of the consolidated financial statements of the group.

INCOME TAX TREATIES

As of February 15, 2017, Belgium has in effect more than 90 income tax treaties with the jurisdictions listed below.

Albania	Algeria	Argentina	Armenia
Australia	Austria	Azerbaijan	Bahrain
Bangladesh	Belarus	Bosnia & Herzegovina	Brazil
Bulgaria	Canada	Chile	China
Dem. Rep. of Congo	Croatia	Cyprus	Czech Republic
Denmark	Ecuador	Egypt	Estonia
Finland	France	Gabon	Georgia
Germany	Ghana	Greece	Hong Kong
Hungary	Iceland	India	Indonesia
Ireland	Israel	Italy	Ivory Coast
Japan	Kazakhstan	Kosovo	Kuwait
Kyrgyzstan	Latvia	Lithuania	Luxembourg
Macedonia	Malaysia	Malta	Mauritius
Mexico	Moldova	Mongolia	Montenegro
Morocco	Netherlands	New Zealand	Nigeria
Norway	Pakistan	Philippines	Poland
Portugal	Romania	Russia	Rwanda
San Marino	Senegal	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sri Lanka	Sweden	Switzerland
Taiwan	Tajikistan	Thailand	Tunisia
Turkey	Turkmenistan	Ukraine	United Arab Emirates
United Kingdom	United States	Uzbekistan	Venezuela
Vietnam			

Belgium has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

SWEDEN

Author
Peter Utterström
Peter Utterström Advokat AB
Stockholm, Sweden

The author would like to acknowledge the contribution of Daniel Gustafsson, an assistant judge at the Administrative Court of Stockholm, in the preparation of this article.

IN GENERAL

Sweden has emerged as an attractive country for establishing financing and holding companies for both E.U. and non-E.U. corporations. However, intra-group interest restrictions may affect this status negatively. The key features of the Swedish holding company regime are

- a very favorable participation exemption regime for both dividends and capital gains;
- no thin capitalization rules;
- no withholding taxes on outbound interest payments;
- an extensive network of double tax treaties (more than 80 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains;
- a low corporation income tax rate (*i.e.*, 22%) with indications that it may drop further;
- relatively low requirements on minimum share capital – SEK 50,000 (approx. €6,000); and
- no withholding tax on dividend distributions to qualified U.S. shareholders (with a minimum holding of 80% of the votes and minimum holding period of 12 months) or 5% withholding tax for holdings amounting to 10% or more of the votes (with no holding period requirement).

The main legal entity used for holding and financing purposes is the Swedish limited liability company ("*Aktiebolag*" or "A.B."). The A.B. has both legal competence and the formal capacity to act as a party before authorities and courts, and it is a legal entity for Swedish tax purposes. An A.B. is also a qualifying entity under the Swedish participation exemption.

PARTICIPATION EXEMPTION

General

The net income of a Swedish company is normally subject to corporation income tax at a rate of 22%. However, if both the holding company and the subsidiary are qualifying entities under the participation exemption, income from capital gains and dividends are tax exempt. According to Chapter 24 of the Swedish Income Tax Act ("I.T.A."), the holding entity must be in one of the following forms in order to qualify:

- A Swedish A.B. or a Swedish economic association that is not an investment company
- A Swedish foundation or a Swedish non-profit association that is not subject to tax exemption according to Chapter 7 I.T.A.
- A Swedish savings bank
- A Swedish mutual insurance company
- A "foreign company" resident within the E.E.A. that is the equivalent of any of the foregoing entities

The term "foreign company" is defined in the I.T.A. as a foreign legal entity that is subject to tax in its country of residence, if such taxation is similar to the taxation of a Swedish A.B. In general, a tax rate of 60% of the Swedish statutory rate is acceptable, *i.e.*, currently 14% (60% of 22%) or more. Also, a foreign legal entity resident in a country with which Sweden has signed a double tax treaty is always deemed a "foreign company" if the entity is entitled to the benefits of the treaty and the treaty is not limited to certain types of income.

The share held must be a share in an A.B., an economic association, or a similar foreign entity (see **Qualifying Foreign Entities** below). The share must also be a capital asset (*e.g.*, assets other than trading stock, inventory, work-in-progress, receivables and similar assets, equipment, patents, and other intangibles). Additionally, it must meet one or more of the following criteria:

- The share is not listed.
- The holding entity owns shares representing at least 10% of the total number of votes of the company.
- The holding is deemed necessary for the business conducted by the owner or any other company within the community of interests of the owner.

If both the holding entity and the subsidiary fulfill the abovementioned conditions, the shares held are deemed "business-related shares," and thus qualify under the participation exemption.

Dividends

In general, dividends received from business-related shares are tax exempt. If the shares are listed, they must be held for a period of at least one year from the time when the shares became business-related for the holding entity. Also, dividends on shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

Capital Gains

Capital gains on the disposal of business-related shares are tax exempt. Accordingly, capital losses derived from the disposal of those shares are not tax deductible. If the shares are listed, the capital gains are tax exempt, provided that they have been deemed business-related shares, with regard to the seller, for at least one year immediately preceding the disposal.

Capital gains arising from the disposal of an interest in a Swedish partnership or a foreign tax-transparent entity resident within the E.E.A. are tax exempt if the interest is owned by a company qualified for holding business-related shares. Also, capital gains arising from shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

> *"A 30% withholding tax is levied upon the distribution of dividends by a Swedish A.B. However, . . . withholding tax will not be imposed or will be imposed at a reduced rate in most cases."*

Qualifying Foreign Entities

Shares in foreign legal entities may also qualify as business-related shares if the legal entity corresponds to a Swedish limited liability company. The relevant provisions in the I.T.A. do not state what conditions should be met in order for a foreign legal entity to correspond to a Swedish A.B. In a case regarding a Russian limited liability company ("O.O.O."), the Supreme Administrative Court based its decision mainly on the resemblance, from a civil law perspective, between an O.O.O. and a Swedish limited liability company. In addition, the O.O.O. in question was subject to income tax in Russia. Therefore, it was deemed to correspond to a Swedish limited liability company. So far, a large number of foreign legal entities have been deemed to correspond to Swedish A.B.'s by the Supreme Administrative Court and the Board for Advance Tax Rulings.

WITHHOLDING TAX

Outbound Dividends

Under the Swedish Withholding Tax Act ("W.T.A."), a 30% withholding tax is levied upon the distribution of dividends by a Swedish A.B. However, due to the implementation of the E.U. Parent-Subsidiary Directive ("P.S.D.") and Sweden's extensive network of double tax treaties, withholding tax will not be imposed or will be imposed at a reduced rate in most cases. Under the double tax treaty concluded between the U.S. and Sweden, for instance, Sweden may not impose withholding tax on dividends if the U.S. holding in the Swedish company amounts to at least 80% of the votes and has been in place for at least one year. If the size of the holding is below 80% but 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 Article 2 of the P.S.D.

Additionally, if the shares in the distributing company are deemed business-related shares under the participation exemption regime and the dividend (or capital gains at disposal of the shares) would have been tax exempt if the entity holding the shares had been a Swedish company, the dividend is exempt from withholding tax.

Inbound Dividends

Withholding tax on distributions from foreign subsidiaries is often eliminated under the P.S.D. or reduced under a double tax treaty (see **Treaty Chart** below).

Treaty Chart

Sweden currently has over 80 double tax treaties in effect, in addition to a vast number of tax information exchange agreements ("T.I.E.A.'s"). Double tax treaties are in effect with the following jurisdictions:[1]

Albania	Argentina	Australia	Austria
Bangladesh	Barbados	Belarus	Belgium
Bermuda	British Virgin Islands	Bolivia	Botswana
Brazil	Bulgaria	Canada	Cayman Islands
Chile	China	Cyprus	Czech Republic
Denmark	Egypt	Faeroe Islands	Finland
France	Hong Kong	Estonia	Gambia
Germany	Iceland	Iran	Ireland
Israel	Italy	Jamaica	Japan
Kazakhstan	Latvia	Lithuania	Mauritius
Mexico	Namibia	Netherlands	New Zealand
Norway	Oman	Peru	Philippines
Poland	Portugal	Romania	Russia
Singapore	Slovakia	South Africa	Spain
Sri Lanka	Switzerland	Taiwan	Tanzania
Thailand	Trinidad & Tobago	Tunisia	Turkey
Ukraine	United Kingdom	United States	Uruguay
Venezuela	Vietnam	Zambia	Zimbabwe

Sweden has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

FINANCING

Loan Financing

As a general rule, all interest payments are deductible without limitation. Sweden does not impose withholding tax on interest payments. As there are no thin capitalization rules (*i.e.*, interest deductibility is not dependent on the fact that a certain debt-to-equity ratio is upheld), highly leveraged structures can be used.

From a transfer pricing perspective, the interest rates charged must be at arm's length. Interest rates charged between related parties may be – and most often are – challenged by the Swedish Tax Agency ("S.T.A.").

Limitations exist on deductions for interest expense attributable to loans from affiliated companies. Interest charged to the Swedish company will qualify for tax deduction only in cases where debt financing is in place for commercial reasons. This regulation is a reaction to the seemingly widespread practice of employing Swedish tax structures to reduce Swedish corporate taxation using intercompany loans from low tax jurisdictions.

---

[1] The treaty concluded between Sweden and the former Kingdom of Yugoslavia remains applicable to the present-day republics of Bosnia & Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, Slovenia, and Serbia.

Equity Contributions

In addition to traditional equity investments, under Swedish law, there are two types of shareholders' contributions available: conditional and unconditional contributions. An unconditional contribution is a final investment in the company, without a claim for future repayment. An unconditional contribution is not deemed to be taxable income for the company. However, it is indirectly a deductible expense for the contributor, since the contribution is added to the tax basis of the shares and is thus deductible when calculating future capital gains or losses – if the investment is a taxable investment – on the disposal of the shares.

A conditional contribution is deemed to be a loan for tax purposes. Repayment of a conditional contribution is not regulated in Swedish tax law, but according to case law, a repayment is generally treated as the repayment of a loan and, thus, is not a taxable event, unless special circumstances are at hand.

Sweden does not impose any transfer tax or stamp duty on equity contributions.

LIQUIDATION

Distributions

Under the I.T.A., the liquidation of a company is deemed a taxable disposal of the shares issued by the liquidated company. Thus, an individual shareholder is normally taxed on the difference between the amount distributed during the liquidation and his/her tax basis in the shares. If the shares are business-related shares, no capital gains or losses will be recognized. For foreign shareholders, a distribution in connection with the liquidation of a company is deemed to be a distribution of a dividend. Thus, withholding tax will be levied on the distributed (gross) amount unless treaty rules provide otherwise. If the company is dissolved within two years of the distribution, the shareholder's acquisition value for the shares may be deducted. The taxpayer will receive a reimbursement for the amount of withholding tax paid which exceeds the amount of tax imposed on the difference between the distributed amount and the acquisition value. However, as mentioned in **Withholding Tax** above, withholding tax will in most cases be eliminated or imposed at a reduced rate.

Losses

Final losses on the liquidation of foreign subsidiaries give rise to a special group deduction ("*koncernavdrag*"). The deduction is a result of Sweden becoming an E.U. Member State. However, it applies only in very restricted circumstances, as illustrated by the following conditions, which must be met in order for a group deduction to be allowed:

- The foreign subsidiary must be located within the E.U.
- The foreign subsidiary must be liquidated.
- Until the liquidation is completed, the foreign subsidiary must have been wholly-owned either during the entire fiscal year of both the parent and the subsidiary, or since it started conducting business of any kind.
- The deduction of the group contribution must be made in connection with the

tax assessment of the fiscal year during which the liquidation is completed.

- The deduction of the group contribution must be openly disclosed in the tax assessment of the parent company.
- None of the companies within the parent company's community of interests may conduct business in the domicile state of the subsidiary after the completion of the liquidation.

A loss is considered final only if the subsidiary, or another person in the domicile state of the subsidiary, has utilized the loss and will not be able to utilize it in the future. If the loss is not utilized because the law of the domicile state does not provide for such a possibility or because such a possibility is limited in time, the loss will not be considered final.

There are also limitations to the amount that may be deducted. The deduction may not exceed the loss of the foreign subsidiary at the end of the last complete fiscal year before the end of the liquidation or before the liquidation. The deduction may not exceed the positive result of the parent company before the deduction. When calculating the result of the parent company, any group contribution received from the subsidiary after it became wholly-owned is disregarded if such a contribution has caused or increased the loss in the subsidiary.

NET OPERATING LOSSES

The taxable result of a business is calculated as the difference between gross taxable income and allowed deductions. Net operating losses ("N.O.L.'s") can be utilized by means of a carryforward. Excess N.O.L.'s are forwarded to the next fiscal year and used as a deduction when calculating the taxable result of the business. N.O.L.'s from previous years may be carried forward indefinitely.

If a company acquires a controlling interest in a company with N.O.L.'s from previous years, certain restrictions apply regarding the use of those N.O.L.'s. First, the N.O.L. deduction is capped at 200% of the acquisition price. Second, the Swedish practice of moving losses within a group through contributions that are deductible for the payer and income for the recipient are not allowed until the sixth year following the year in which the loss company was acquired. These restrictions do not apply to group internal restructurings.

The above applies only to N.O.L.'s incurred during past fiscal years. N.O.L.'s incurred during the current fiscal year – the year of acquisition – are not subject to any restriction.

TRANSFER PRICING

Sweden applies a transfer pricing provision based on the O.E.C.D.'s arm's length principle. In practice, this means that prices charged between related parties must be set in accordance with market rates. If internal pricing deviates from the rates charged by independent parties and the taxable result of the Swedish company is therefore reduced, the S.T.A. may challenge the taxable result. Additionally, Swedish companies are required to keep documentation on cross-border transactions with related parties.

In order to avoid future transfer pricing conflicts with the S.T.A., it is possible to apply for a binding Advance Pricing Agreement ("A.P.A."). The fee for obtaining an A.P.A. is currently SEK 150,000 (approximately €19,000). The agreement is normally valid for three to five taxable years.

As is the case in other countries, the S.T.A. has increased its focus on transfer pricing matters in recent years. It is likely that the abovementioned rules will be modified as a result of the O.E.C.D.'s initiative to combat base erosion and profit shifting (the "B.E.P.S. Project") and there is a clear trend that the S.T.A. will be more aggressive in challenging intercompany pricing and transactions. Accordingly, the S.T.A. will likely further enhance its focus on intercompany transactions and the requirements for documentation and information from the taxpayer. Additional comments on B.E.P.S. will be made separately, under **Base Erosion and Profit Shifting** below.

CONTROLLED FOREIGN CORPORATIONS

The purpose of the Swedish controlled foreign corporation ("C.F.C.") rules is to prevent Swedish persons or companies from deferring or avoiding taxation by collecting funds in a foreign subsidiary resident in a low tax jurisdiction. If a foreign subsidiary is deemed to be a C.F.C., a shareholder subject to tax in Sweden will be taxed directly for an appropriate share of the C.F.C.'s profit – as calculated under Swedish generally accepted accounting principles and tax rules, irrespective of whether any funds have been distributed. Any tax paid in the foreign jurisdiction is creditable against Swedish tax.

In order for the C.F.C. rules to be applicable, the foreign corporation must be subject to low tax, which is defined as a tax rate lower than 55% of the Swedish corporate tax rate (*i.e.*, 12.1%). The controller (*i.e.*, the person subject to C.F.C. taxation) must own or control at least 25% of the capital or votes of the foreign corporation alone or together with persons in a communal interest with the controller.

There are two exceptions from the C.F.C. rules:

- First, regardless of the level of taxation, a foreign legal entity is deemed not to be a C.F.C. if it is resident for tax purposes in a country mentioned on the so-called "whitelist." If Sweden has concluded a double tax treaty with such a country, the exception from the C.F.C. rules is only applicable on income that falls within the scope of the treaty.
- Second, if the C.F.C. is resident for tax purposes within the E.E.A. and is deemed to be a "real establishment" from which a commercially motivated business is conducted, the C.F.C. rules are not applicable.

BASE EROSION AND PROFIT SHIFTING

Sweden has slowly taken an increased interest in combatting B.E.P.S. and in the development of the B.E.P.S. Project at the level of the O.E.C.D. As of May 2017, the influence of the B.E.P.S. Project is mainly seen in legal debates and, possibly, in tax courts. No new Swedish regulations, recommendations, or case law developments have come, specifically, out of the B.E.P.S. Project, with the exception of the new legislation enacted in April 2017 to implement B.E.P.S. Action 13 on transfer pricing documentation and country-by-country reporting. Consequently, the B.E.P.S. Project has primarily had only an indirect effect in Sweden. Nonetheless, it is clear that the S.T.A. is learning from the analysis and comments made by different parties, and the S.T.A. (and its Nordic counterparts) will be even more active in issues concerning permanent establishments, transfer pricing, and intercompany transactions. Information exchange – whether as a result of B.E.P.S., F.A.T.C.A., or the Common Reporting Standard ("C.R.S.") – will also trigger more activities. Long term, it is assumed that the B.E.P.S. Project will trigger an increased documentation and compliance burden for taxpayers, but not necessarily much new legislation or changes to the I.T.A. It is important to keep in mind that many of the B.E.P.S. Actions will not require an actual change of law (as effected ultimately by the Swedish Parliament), but a change of the O.E.C.D. Guidelines, which will be utilized as a point of reference by the S.T.A. and implemented by the tax courts. In this context, legislators in most countries have been driven by media attacks on the tax planning methods of multinational groups, and the likely effect is that more "double taxation" will occur in order to prevent "double nontaxation."

"Many of the B.E.P.S. Actions will not require an actual change of law (as effected ultimately by the Swedish Parliament), but a change of the O.E.C.D. Guidelines."

DENMARK

Author
Nikolaj Bjørnholm
Bjørnholm Law
Copenhagen, Denmark

IN GENERAL

For years, Denmark has been attractive to foreign investors for several commercial reasons, such as its highly developed infrastructure, well-educated populace, and uncomplicated rules governing the termination of employment.

The investor-friendly environment is supported by a corporate tax regime primarily designed for operating entities, which generally allows for

- a corporation income tax rate of 22%;
- zero corporate tax on inbound dividends received by a Danish company with a participation of at least 10% in a subsidiary situated in the E.U. or a country which has a double tax treaty with Denmark, or if the Danish company and the subsidiary are eligible for tax consolidation;
- zero withholding tax on outbound dividends to corporate parents having a participation of at least 10% that are resident in the E.U./E.E.A. or treaty countries (subject to an anti-abuse rule discussed below); and
- reduced tax on inbound and outbound dividends on portfolio shares (shareholdings of less than 10%) due to a strong network of tax treaties with approximately 80 countries.

The Danish corporate tax regime also provides for

- no capital duty on capital contributions;
- no stamp or transfer duty (save in the form of registration charges) with respect to fixed property, ships, and aircraft;
- no capital gains taxation on share profit at the level of the Danish company, provided that the Danish company owns at least 10% of the shares in the subsidiary, and no tax on capital gains from the disposition of non-listed portfolio shares (holdings of less than 10%) of a Danish private limited company or a similar foreign company (see **Capital Gains Taxation** below);
- no wealth tax on foreign investors within the 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, such as

- Danish-controlled financial company rules under which investments in foreign finance companies do not benefit from the Danish holding company regime;
- corporate law restrictions on the up-streaming of cash flow to foreign investors through loans from a Danish holding company or through the provision of security for the indebtedness of a foreign investor;
- tax legislation targeting debt-leveraged acquisitions of Danish companies, in particular, international tax planning strategies involving U.S.-Danish check-the-box structures, and in general, hybrid entities and loans; and
- to prevent the use of Denmark as an intermediary to reduce withholding tax in other countries, Denmark applies its internal exemption from withholding tax and instead applies 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 ("P.S.D."), and (iii) the Danish company is not the beneficial owner of the dividends it received (known as a "conduit situation"). (See **Tightening of the Rules for Dividend Withholding Tax Exemption** below.)

"A Danish company is subject to Danish income taxation at a flat rate of 22%. This rate applies whether or not profits are distributed."

CORPORATION INCOME TAX

A Danish company is subject to Danish income taxation at a flat rate of 22%. This rate applies whether or not profits are distributed.

A modified principle of worldwide income taxation applies. A Danish company is generally taxed on the basis of a territorial principle in relation to profits from foreign real property and profits from a foreign permanent establishment. 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 **General Anti-Abuse Clauses** below), profits and losses from foreign real property and from permanent establishment 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 tax treaty. No local income taxes are levied by cities or regions on companies or branches in Denmark.

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 P.S.D. or a tax treaty concluded by Denmark and the foreign subsidiary country.

As of May 10, 2017, Denmark has income tax treaties in effect with the following jurisdictions:

Armenia	Argentina	Australia	Austria
Bangladesh	Belarus	Belgium	Brazil
Bulgaria	Canada	Chile	Croatia
Cyprus	Czech Republic	China	Egypt
Estonia	Faeroe Islands	Finland	Georgia
Germany	Ghana	Greece	Greenland
Hungary	Iceland	India	Indonesia
Ireland	Israel	Italy	Jamaica
Japan	Kenya	Kuwait	Kyrgyzstan
Latvia	Lebanon	Lithuania	Luxembourg
Macedonia	Malaysia	Malta	Mexico
Montenegro	Morocco	Netherlands	New Zealand
Norway	Pakistan	Philippines	Poland
Portugal	Romania	Russia	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Sri Lanka	Sweden	Switzerland
Taiwan	Tajikistan	Tanzania	Thailand
Trinidad & Tobago	Tunisia	Turkey	Turkmenistan
Uganda	Ukraine	United Kingdom	United States
Uzbekistan	Venezuela	Vietnam	Zambia

Denmark has concluded limited tax information exchange agreements ("T.I.E.A.'s") with the following jurisdictions:

Andorra	Anguilla	Antigua & Barbuda	Aruba
Bahamas	Bahrain	Barbados	Belize
Botswana	Brunei	Cook Islands	Costa Rica
Dominica	Gibraltar	Grenada	Guatemala
Liberia	Liechtenstein	Macao	Marshall Islands
Mauritius	Monaco	Netherlands Antilles	Niue
Panama	Qatar	Samoa	San Marino
St. Kitts & Nevis	St. Lucia	St. Vincent & the Grenadines	Seychelles
Turks & Caicos	Vanuatu		

Treaties confined to individuals, international shipping, air transport, and Mutual Agreement Procedures have been concluded with Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Hong Kong, the Isle of Man, Jersey, and Jordan. Denmark has further ratified the launch of the Convention on Mutual Administrative Assistance in Tax Matters, developed by the O.E.C.D. and the Council of Europe, including the 2010 protocol. More than 84 countries have also ratified the convention. Denmark has also signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

CORPORATE TAXATION OF INBOUND DIVIDENDS

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

- The foreign subsidiary qualifies as a "company" under Danish law.
- Either (i) the Danish company holds at least 10% of the shares of the foreign subsidiary, and the foreign subsidiary is covered by the P.S.D. or is resident in a state that has concluded a double tax 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).
- The dividend is not received from a non-E.U. entity which has taken a tax deduction with respect to the dividend payment.

If the Danish company directly or indirectly holds less than 10% of the foreign subsidiary, 70% of the dividend payment will be subject to tax at the standard corporation income tax rate of 22%.

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, the entity (i) carries on business for profit, (ii) has a fixed share capital, (iii) provides limited liability for all its shareholders, and (iv) apportions the claim on its profits 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 P.S.D. If for some reason the P.S.D. is inapplicable, the entity will be characterized under the four-pronged standard that generally applies.

C.F.C. TAXATION

Danish tax law contains controlled financial company ("C.F.C.")[1] 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 its *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 **Interest Withholding Tax and Check-the-Box Countermeasures** below).

[1] Although internationally "C.F.C." is often defined as a "controlled foreign corporation," here the term "controlled financial company" is used as Danish C.F.C. legislation is not confined solely to foreign entities.

Generally, group-relation exists if the Danish company directly or indirectly holds more than 50% of the foreign subsidiary's voting rights.

- The C.F.C. income comprises more than half of the aggregate taxable income of the foreign subsidiary.
- The subsidiary's financial assets represent more than 10% of its total assets.

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

- net interest income;
- net gains on receivables, debts, and financial instruments;
- certain commissions;
- dividends;
- net capital gains on shares, but only to the extent that they are taxable under Danish law;[2]
- royalty payments and capital gains arising from intellectual property rights, unless the intellectual property arose from the subsidiary's own research and development activities and the payments in issue are made by an unrelated party;
- deductions claimed for tax purposes by a Danish company that relate to the income items listed above;
- leasing income deriving from financial leases including losses and gains on the assets involved;
- income from insurance, banking, and other financial activities, unless an exemption is otherwise applied for; and
- gains and losses from sale of CO_2 credits and CO_2 quotas.

The assessment is made on the basis of the facts that occur during the year. Losses from previous years that are eligible to be carried forward and group contributions are not considered 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 assessing 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, are not included.

[2] Consequently, dividends and capital gains that benefit from the Danish participation exemption are not considered to be tainted income.

- The shares in lower-tier subsidiaries, which are controlled by the subsidiary and located in the same jurisdiction as the subsidiary, are not included. Instead, the financial assets in the lower-tier subsidiaries are included proportionately in accordance with the subsidiary's direct or indirect ownership share.

CAPITAL GAINS TAXATION

Danish-resident companies are exempt from tax on gains realized on shareholdings of 10% or more. Capital gains realized by a Danish-resident company on shareholdings below 10% in a non-listed company are generally also tax exempt.

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

Share gains derived by a Danish company that do not qualify for tax exemption are subject to tax at the standard corporation income tax rate of 22%.

In general, a nonresident company is exempt from Danish tax on gains realized on shares in a Danish company. However, payment received, or deemed to be received, by a foreign entity in connection with an intra-group transfer of Danish shares will be characterized as a taxable dividend payment if

- the foreign entity transfers shares held in a group-related Danish entity to another group-related entity for consideration consisting of assets other than shares in the group entity effecting the acquisition; 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.[3]

If the above criteria are met, payment received, or deemed to be received, by a foreign entity as consideration for Danish shares will be subject to a Danish dividend withholding tax of 22%. This rate may be reduced by treaty.

Further, an anti-avoidance rule dictates that payments received by a foreign entity in connection with a transfer of shares will be considered a taxable dividend payment if

- the receiving company is without any economic risks from commercial activity;
- the payment consists of assets other than shares in the group entity effecting the acquisition; and
- the transferring foreign entity is not qualified for an exemption from Danish withholding tax on dividends received from the transferred Danish entity prior to the transfer.

---

3 This provision serves a comparable function to §304 of the U.S. Internal Revenue Code of 1986, as amended, in that its effect is to treat gain from the sale of shares into dividend income.

In order to prevent circumvention of the anti-avoidance rule through intercompany sales, commercial activity acquired from a related legal entity less than three years before the sale of shares is not regarded under the "economic risk assessment." For the definition of a related legal entity, see **Thin Capitalization**.

A company without any economic risks from commercial activity is a company where the commercial activity has stopped or where the commercial activity is insignificant.

INTEREST DEDUCTIBILITY LIMITATIONS

Interest expense incurred by corporations is generally deductible in computing taxable income provided that the underlying debt reflects a binding legal commitment to repay the face amount borrowed. Interest paid to related parties must be calculated on an arm's length basis. Interest expense incurred on certain debt owed to the government is not tax deductible. An example is the interest that accrues on unpaid tax.

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 that the Danish company has Controlled Debt exceeding a *de minimis* threshold of DKK 10,000,000 (approximately €1,343,000). Further, the thin capitalization rules only apply to the extent that the debt-to-equity ratio exceeds 4:1. In such a case, the limitation of the interest deduction applies to the portion of the Controlled Debt that exceeds the 4:1 threshold. Taxpayers that have such excess debt are typically advised to convert the excess into equity to avoid the limitation of deductibility.

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

- is controlled by the Danish Debtor,
- controls the Danish Debtor, or
- is group-related with the Danish Debtor.

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

"Group-related entities" mean two or more entities that are (i) directly or indirectly controlled by the same group of shareholders or (ii) under common management. The lender and the Danish Debtor may be considered 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.

To combat aggressive use of hybrid entities that are treated as disregarded entities under U.S. tax law, those disregarded entities are considered under the above definitions. Consequently, fiscally-transparent entities may be considered entities that have separate legal personality and identity for purposes of the thin capitalization rules if they "are governed by rules of corporate law, a corporate law agreement or articles of association."

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.

Additional Limitations

The Danish corporate tax regime includes two additional limitations on the deductibility of financial expenses that apply to Controlled Debt and third-party debt.

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

- A limitation based on debt-to-equity ratio (the thin capitalization rules, see **Thin Capitalization** above)
- A limitation based on the tax value of assets ("Asset Limitation Rule"), entailing that net financing expenses exceeding DKK 21,300,000 (approximately €2,862,000) are deductible up to a cap of 3.2% (2017 figure) of the tax basis of the Danish operating assets
- A limitation based on annual profits ("E.B.I.T. Limitation Rule"), entailing a maximum interest deduction of 80% of E.B.I.T., which only applies if the net financing expenses exceed DKK 21,300,000 (approximately €2,862,000)

"fiscally-transparent entities may be considered entities that have separate legal personality and identity for purposes of the thin capitalization rules if they 'are governed by rules of corporate law, a corporate law agreement or articles of association.'"

Calculation of Net Financial Expenses

For the purposes 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 expense (excluding interest income/expense from trade debtors and creditors);
- loan commission fees and similar expenses;
- taxable capital gains and losses on claims, debts, bonds, and financial instruments (excluding gains/losses on claims acquired in trade if the contracting party is a related party);
- gains/losses on forward contracts relating to the hedging of operating income (provided that the forward contracts are not acquired in trade);
- deemed finance charges relating to financial leasing arrangements (defined in accordance with I.A.S. 17);
- taxable capital gains and deductible capital losses; and
- taxable dividends.

Interest expense and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses. The calculation of net financial expenses is made on a group basis for Danish companies, which are subject to Danish tax consolidation. If the Danish company/group has net financial expenses exceeding the DKK 21,300,000 threshold, such net financial expenses will be subject to restrictions under the Asset Limitation Rule and the E.B.I.T. Limitation Rule as discussed below.

Restrictions Under the Asset Limitation Rule

Net financial expenses in excess of DKK 21,300,000 will be deductible only in an amount corresponding to 3.2% of the tax value of certain assets.

For the purposes of computing the 3.2% ceiling, only certain qualifying assets are considered, including, *inter alia*, the following:

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

Shares are not considered qualifying assets. Claims, notes, and financial instruments are not considered qualifying assets, either. This means that the value of the foreign exchange notes to be purchased by Danish Newco will not be included in the computation of the 3.2% ceiling. For companies subject to Danish tax consolidation, the computation of the 3.2% ceiling is made on a consolidated basis.

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

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

Net financing expenses below DKK 21,300,000 will never be restricted under the E.B.I.T. Limitation Rule, but may be restricted under the thin capitalization rules which, however, only apply on Controlled Debt. The DKK 21,300,000 ceiling (which is not adjusted annually) is calculated on a group basis for Danish companies that are subject to Danish tax consolidation.

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

WITHHOLDING TAX ON OUTBOUND DIVIDENDS

Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for an elimination or reduction of the Danish withholding tax by virtue of the P.S.D. (as amended by

Council Directive 2015/121/E.U.) or a tax treaty between Denmark and the parent company's state of residence. If these conditions are not met, a 22% withholding tax is levied, subject, however, to subsequent refund if a lower rate is provided by treaty.

TIGHTENING OF THE RULES FOR DIVIDEND WITHHOLDING TAX EXEMPTION

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 exempt 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 P.S.D. The new provision will therefore only affect corporate shareholders resident in jurisdictions that have a tax treaty with Denmark, such as the U.S.

BASE AND EROSION PROFIT SHIFTING

Denmark has already implemented many B.E.P.S. Actions in Danish law, and is accordingly well ahead of the O.E.C.D. schedule for implementation.

With respect to Action Item 2 on hybrid mismatches, see **Interest Withholding Tax and Check-the-Box Countermeasures** below discussing §2A of the Danish Corporation Tax Act, which has been enacted to counteract U.S.-Danish check-the-box structures. Further, debt to foreign persons or entities is deemed equity if the debt is treated as equity in the lender's country of residence. This rule is not triggered if the lender is taxed on the yield as interest in the lender's country of residence.

With respect to Action Item 3 on C.F.C. Taxation, see **C.F.C. Taxation** above. As described, Denmark has implemented detailed C.F.C. rules, which are generally wide in scope.

With respect to Action Item 4 on limiting base erosion via interest deductions, see **Interest Deductibility Limitations** above. As is evident, Denmark operates strict measures to counteract base erosion through the use of excessive interest payments. These rules are supplemented by the anti-avoidance rule mentioned above, whereby debt to foreign lenders is treated as equity in Denmark if the loan is treated as equity in the lender's country of residence. Denmark also employs an aggressive approach when assessing the terms of intra-group loans, and will generally challenge excessive interest payments out of Denmark.

With respect to Action Item 5, Denmark has concluded a number of treaties on exchange of information with various tax havens to ensure a well-founded basis for taxation in Denmark.

With respect to Action Item 6 on preventing treaty abuse, see **General Anti-Abuse Clauses** below, which outlines the contents of two newly-introduced general anti-abuse clauses. As these treaty abuse rules were only recently adopted, the scope of their implementation is not yet clear.

With respect to Action Items 8, 9, and 10, see **Transfer Pricing** below on the Danish transfer pricing rules. The arm's length principle in Danish law is defined in accordance with O.E.C.D. Guidelines, and the Danish tax authorities recognize the methods set out in the guidelines.

GENERAL ANTI-ABUSE CLAUSES

Denmark has adopted two general anti-abuse rules ("G.A.A.R.'s") as of May 1, 2015: an E.U. tax directive G.A.A.R. and a tax treaty G.A.A.R.

The E.U. tax directive G.A.A.R. applies to cross-border transactions that fall within the P.S.D. (2011/96/E.C.), the Interest and Royalty Directive (2003/49/E.C.), and the Merger Directive (2009/133/E.C.). The E.U. tax directive G.A.A.R. implements the mandatory G.A.A.R. of the P.S.D. (amendment by Directive 2015/121/E.U.).

The tax treaty G.A.A.R. is worded slightly differently than the E.U. tax treaty G.A.A.R., but will presumably be interpreted to have the same content. With the enactment of the tax treaty G.A.A.R., Denmark has moved ahead of B.E.P.S. Action 6 in this respect.

The newly-introduced G.A.A.R.'s entail that taxable persons will not benefit from the P.S.D., the Interest and Royalty Directive, the Merger Directive, and tax treaties if the principal purpose of a transaction or arrangement is to achieve a tax benefit which is not in accordance with the directives or the tax treaty and which is artificial in nature.

Thus far, the Danish courts have applied certain measures to disregard transactions carried out for tax purposes (namely the "substance over form" doctrine).

The explanatory remarks accompanying the newly-introduced bill state that the new G.A.A.R.'s may have a wider scope than the existing doctrine of "reality in transactions," but fail to specify in which situations the G.A.A.R.'s are applicable.

The newly introduced G.A.A.R.'s raise serious uncertainty with respect to international tax planning, as it is unclear to what extent the Danish tax authorities can and will try to deny the benefit of the E.U. tax directives and double tax treaties to taxable persons seeking to reduce tax liability.

It is expected that Danish tax authorities will issue further guidance on how the G.A.A.R.'s are to be applied in practice. Until then, great uncertainty remains.

INTEREST WITHHOLDING TAX AND CHECK-THE-BOX COUNTERMEASURES

As a starting point, a 22% withholding tax applies to interest payments made by a Danish company to a foreign related entity. (See definition of related legal entity above in **C.F.C. Taxation** 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.
- The foreign related lender is protected under the Interest and Royalty Directive (2003/49/E.U.) (no tax is levied and no withholding tax applies).
- The foreign related lender is protected under a tax treaty with Denmark (irrespective of treaty rate).
- The foreign related lender is controlled (as defined under Danish C.F.C. rules) by a Danish entity.
- The foreign related lender is controlled by a party resident in a country that has concluded a tax treaty with Denmark, and further, that such country may tax the lender on such interest payments pursuant to C.F.C. taxation rules of that country.
- 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 16.5%, equivalent to three-fourths of the normal Danish flat corporate tax rate, and further provides that it has not entered into a back-to-back loan with an entity that has paid foreign income tax on the interest received at a rate of less than 16.5%.

The interest withholding tax rule is part of a dual regime, which aims to curb international tax planning based on leveraged structures where the foreign lender is not taxed on the interest income received from a Danish company. Together with the interest withholding tax rule, a special rule (§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 §2A is to counteract certain U.S.-Danish check-the-box structures.

The mechanisms of §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 in the following cases:

- 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 **Interest Deductibility Limitations**).
- 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 that are treated as fiscally-transparent by the foreign parent company. (See modification immediately below.) The payments would be considered to be within the same legal entity. This also means, however, that irrespective of the general requirements, dividend payments made to the foreign parent company would not be subject to any Danish withholding tax.

"The Danish tax authorities are now allowed to request a special auditor's statement concerning transfer pricing documentation."

As an exception to the general rule outlined above, payments made by a §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. Member State or a treaty state and that state is different from the state where the parent company is resident. It should be noted that §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, certain tax consolidation rules such as those in the U.S. may be considered to have the same effect as fiscal transparency and therefore may trigger §2A status. The paradigm is a U.S. company that has a branch in Denmark. The U.S. company or head office may be deemed transparent under Section 2A if the head office is tax consolidated with a U.S. parent company. In such an event, payments made by the Danish branch to the U.S. parent company would be considered to be within the same legal entity and thus not deductible.

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

TRANSFER PRICING

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

When filing its tax returns, a Danish company must report the type and scope of transactions with related legal entities. In addition, a Danish company is required to prepare and keep documentation on the methods used in determining the prices and terms of the transactions with related parties. Documentation may be prepared in Danish, Swedish, Norwegian, or English.

Small- and medium-sized companies are relieved of the obligation to prepare documentation. These businesses are only required to prepare documentation for transactions with related companies resident outside the E.U., and only if Denmark does not have a double tax treaty with the country in question. Small- and medium-sized companies include companies which, on a consolidated basis, have (i) less than 250 full time employees during a year, and (ii) either assets below DKK 125,000,000 (approximately €16,798,000) or turnover below DKK 250,000,000 (approximately €33,592,000).

The penalty for noncompliance is calculated on different objective criteria and based on the potential tax advantage. However, a fixed penalty of DKK 250,000 (basic amount) applies, plus 10% of the increased income if noncompliance resulted in economic gain.

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

GROUP OF COMPANIES – JOINT CROSS-BORDER TAXATION

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

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

- has the majority of the voting rights in another company;
- is a shareholder and has the right to appoint or dismiss a majority of the members of another company's management;
- is a shareholder and is entitled to exercise control over another company's operational and financial management on the basis of the articles of association or agreement with that other company;
- is a shareholder and controls the majority of the voting rights in another company on the basis of a shareholder's agreement; or
- is a shareholder in another company and exercises control over that company's operational and financial management.

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

The taxable income of the consolidated group is computed company by company. The consolidated income is created by netting out the taxable results so that losses in one company offset profits in another. Losses incurred by a group company before entering 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 corporation income tax.

The ability to claim a benefit from a loss carryforward is limited. A loss of DKK 8,025,000 (2017 figure) 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 regards to the recapture of foreign tax losses upon the termination of a tax consolidation scheme established under the old regime.

INTERIM DIVIDENDS

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

BINDING ADVANCE RULING

Binding rulings, including advance rulings, on specific proposed transactions can be obtained from the Danish Tax Authority. A fee (currently approximately €50) is charged for a binding ruling. Persons not subject to Danish tax liability are also entitled to ask for binding rulings. Binding rulings are generally issued within one to three months, but may be issued much later for complex issues. Binding rulings can be appealed to either the National Tax Tribunal or to a tax appeal committee, whose decisions can be appealed to the City Courts and the High Courts.

The binding ruling will be binding for the tax authorities for a period of five years. However, it is possible for the tax authorities to shorten the period if required by the circumstances. The ruling is binding to the extent that the facts presented by the taxpayer upon submission of the request for the ruling do not differ from the actual facts of the transaction.

Binding rulings on the value of an asset transferred will no longer be binding if the value subsequently deviates significantly from the value set in the binding ruling. A significant deviation is at least DKK 1,000,000 (approximately €134,000) and at least 30%.

The assessment of whether the value of an asset has deviated from the time the binding ruling was issued may be based on either subsequent sale prices obtained by the buyer of the asset (via a direct or indirect sale), or the revenue subsequently generated by the asset. The binding ruling may be disregarded until the statute of limitations expires, and the tax authorities are allowed to take into consideration all activities that have taken place until this time. Binding rulings on the value of assets transferred are typically only relevant in transfer pricing cases. The statute of limitations for transfer pricing cases expires on May 1 of the sixth year following the relevant tax year, *e.g.*, the value of an asset transfer taking place in the tax year 2017 can be set aside until May 1, 2023, taking into account any developments during this time.

The tax authorities are obliged not to set aside a binding ruling if the subsequent changes to the value of the assets are due to developments, market changes, and so on, that neither could nor should have been considered when the asset's value was originally determined.

AUSTRIA

Author
Robert Schneider
SchneideR'S Rechtsanwalts-KG
Vienna, Austria

INTRODUCTION

Unlike countries such as Switzerland or Luxembourg, Austrian tax law does not contain a specific regime for holding companies. In Austria, a holding company is taxed in the same way as any other company. Nevertheless, the following features of the Austrian tax system make Austria a jurisdiction worth considering for international holding companies:

An international participation exemption for dividends and capital gains received from foreign subsidiaries

- No thin capitalization legislation
- An attractive corporate tax rate of 25%
- No controlled foreign corporation legislation
- No withholding tax on interest paid by non-banks to nonresidents
- No withholding tax on dividends paid to E.U.-resident parent companies
- An extensive network of tax treaties (more than 100, including double tax treaties on net wealth and inheritance taxes) with all major trading partners of Austria, Eastern European countries, and C.I.S. Member States, reducing or eliminating the general withholding tax
- The possibility of obtaining advance tax rulings regarding reorganizations, group taxation, and transfer pricing issues
- A group taxation system that allows Austrian holding companies to deduct losses incurred by qualifying foreign subsidiaries
- Full deductibility of interest expense for loans in connection with the acquisition of subsidiaries that are not already members of the group

CAPITALIZATION OF AUSTRIAN COMPANIES

Equity Contributions

Effective January 1, 2016, equity contributions and profit participating loans to an Austrian company are no longer subject to capital tax.

Loan Capital

Austria does not have a statutory thin capitalization rule. Loan arrangements between an Austrian company and one of its shareholders are generally recognized for tax purposes, provided that the terms of the loan meet the conditions of an arm's length test and a third party would grant a similar loan in light of the financial situation of the company. If not, the loan capital will qualify as equity with the result that interest paid on the loan will not be deductible as a business expense. Instead, interest payments will be treated as hidden distributions to the shareholder.

CORPORATE TAXATION

In General

A company is resident in Austria for tax purposes if it has its legal seat or its effective place of management in Austria. Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 25%. Independent of taxable income, a minimum tax of 5% of the statutory minimum share capital is levied (*i.e.*, €1,750 for limited liability companies and €3,500 for stock companies). During the first ten years after incorporation of a limited liability company, a reduced minimum tax applies. It is €500 for the first five years and €1,000 for the following five years. Any minimum tax payments can be offset against higher tax burdens in the future without limitation.

A nonresident company is taxable on business income derived in Austria if it carries on a business through a permanent establishment in Austria or participates in an Austrian 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 exempt under the participation exemption, or royalties).

Participation Exemption

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

Pursuant to §10/1 of the Austrian Corporate Income Taxation Act ("C.T.A."), an exemption is provided for dividends (or similar distributions of profits) received by an Austrian company from (i) another Austrian company or cooperative, (ii) comparable entities resident in the E.U., or (iii) comparable entities resident in any other country with which Austria has concluded a comprehensive mutual administrative assistance treaty. Neither the extent of the holding nor the period during which the participation is held is taken into account in determining whether the exemption is applicable to a particular dividend.

The tax exemption for portfolio participations in foreign companies is not granted if (i) the foreign entity is not subject to a tax comparable to the Austrian corporation income tax, (ii) the tax rate is less than 15%, or (iii) the foreign entity is subject to a comprehensive set of tax exemptions. In these cases, the dividends paid are not tax exempt, but foreign tax paid is credited against Austrian tax. This is known as a switch-over from an exemption system to a credit system.

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

A different set of exemption provisions applies to participations in non-Austrian companies that qualify as international participations. These are discussed in **Participation Exemption for Qualifying International Participations**, below.

Participation Exemption for Qualifying International Participations

Qualifying International Participations

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

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

Tax Exemptions

Qualifying international participations held by an Austrian company are entitled to exemptions from tax with regard to dividend payments received and capital gains.[1]

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

Capital Gains

Capital gains (or losses) from the alienation of shares and from the liquidation of a foreign company generally are tax neutral pursuant to §10/3 C.T.A. This system of tax neutrality means that capital gains or losses are disregarded and not included in the tax base. In addition, no tax deduction may be claimed for a write-down of the value of the participation. However, losses incurred in the course of the termination of the company by voluntary winding-up or as a result of insolvency remain deductible, but only 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 elects to include these items in its tax base. This election must be made in the tax return filed for the business year in which the qualifying participation has been acquired. The option is irrevocable and extends automatically to any shares in the same company that the Austrian company may subsequently acquire.

---

[1] C.T.A., §10/1, nr. 7.

Regarding a change in tax status due to a subsidiary's transfer of domicile, the following provisions apply to outbound and inbound changes. Should a subsidiary become an "international participation" through the transfer of the Austrian subsidiary's seat to a foreign country, the difference between the book value of the participation and its higher going-concern value at the time of the transfer remains taxable in the case of a later sale of the participation. On the other hand, if a foreign subsidiary loses its "international participation" status by virtue of the transfer of its seat *to* Austria and no election for the taxation of the capital gains and losses 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 the future, with the result that capital losses become deductible.

Anti-Avoidance Provisions

The tax exemption for international participations is not available where the following conditions exist, as set forth under specific anti-avoidance provisions:

"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 main business of the company consists of, directly or indirectly, deriving (i) interest income, (ii) rental income from movable tangible property (*i.e.*, rents from immovable property are not detrimental), or (iii) income from royalties or the alienation of participations (passive income). Dividend income derived, directly or indirectly, from an operating company is not considered passive income.
- The foreign taxation of the company is not comparable to the Austrian system of corporation taxation. According to the International Participation Ordinance of the Ministry of Finance, a foreign tax system is comparable to the Austrian system if the average tax rate of the foreign company computed in accordance with the principles of Austrian tax law exceeds 15%. Foreign taxes that are indirectly imposed on the income of the foreign company are considered when calculating the foreign average tax rate. If the 15% threshold is missed only because the foreign tax law allows a deduction of depreciations on fixed assets or a deduction of loss carryforwards that are not deductible under Austrian law, the foreign corporate taxation is nevertheless deemed to be comparable to Austrian taxation.

In principle, the international participation exemption is denied only if adverse results are reached under both tests. However, if marginally favorable results are reached under one test, and adverse results are clearly reached under the other test, the exemption will be denied.

If the participation exemption is denied, a switch-over to the credit method takes place. Consequently

- dividends and capital gains from the foreign company become taxable at the level of the holding company; and

- upon application by the Austrian holding company, foreign corporation income tax on the profits of and withholding tax on the dividends from the foreign company are credited against the Austrian tax liability, which is charged on dividends and other income distributions received by the Austrian company. The tax credit is itself is grossed-up into income and subject to Austrian tax, much like a Section 78 dividend gross-up under U.S. tax law.[2]

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

In the event that the creditable tax is higher than the Austrian tax, the unused foreign tax credit can be carried forward and may be available as a credit against Austrian tax in following years.

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

Treaty Exemptions

As set out above, the domestic participation exemption regime is in some respects more favorable than the international participation exemption. There is neither a minimum shareholding requirement nor a minimum holding period in the domestic regime. Under tax treaties that include an equal treatment clause, the Austrian company may enjoy the benefits of the international participation exemption for foreign companies resident in the jurisdiction of the treaty state, if the conditions for application of the domestic participation exemption are fulfilled. Such clauses appear in the double tax treaties with Ireland, Luxembourg, Sweden, and Turkey.

Interest Deduction

As a general principle, costs relating to tax-exempt income are not tax deductible in Austria. However, interest payments connected with the financing of domestic or international shareholdings are deductible despite the fact that income derived from such participations is tax exempt. This rule does not apply to other financing costs, such as bank fees. A deduction is not granted for interest payments made in connection with financing for the purchase of intra-group participations. This limitation addresses perceived intra-group tax-avoidance structures.

---

[2] Under Code §78 as currently in effect, the amount of an indirect foreign tax credit for the foreign income tax imposed on the profits giving rise to an actual dividend are themselves treated as additional dividend income. This allows the foreign tax credit to be approximately the same whether a U.S. corporation operates abroad through a foreign branch or a foreign subsidiary.

Group Taxation

Austrian tax law contains a group taxation concept. Consequently, the profits and losses derived by all members of a tax group are taxed at the level of the group parent. Group taxation may be elected independently for each potential group member.

The group parent must be (i) an Austrian company, (ii) an Austrian cooperative, or (iii) an Austrian-registered branch of a nonresident company or cooperative that is either (i) an entity listed in Article 2 of the P.S.D., provided that it is comparable with an Austrian entity that qualifies as group parent, or (ii) 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 E.E.A. Several companies may act jointly as group parent, provided that certain minimum holding requirements 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 parent.

To qualify as a member of a tax group, the group parent or an Austrian group member must hold a direct or indirect participation of over 50% in the Austrian or foreign entity. In the case of a joint group parent, one head company must hold at least 40% and the other parent 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. The election is binding for a period of three years.

All profits and losses of the Austrian members of the group are calculated at the level of the group members, but they are taxed at the level of the group parent. This treatment applies even when a person who is not a group member holds a minority stake in one of the participating subsidiaries. For this reason, it is necessary that the group members agree on compensation payments. These agreements need not be annexed to the filing; it is sufficient that the group members confirm that such agreements exist. The compensation payments themselves will be tax neutral in Austria.

With regard to foreign group members, losses – but not profits – are taken into account. For the purpose of Austrian group taxation, the foreign loss is computed in accordance with Austrian tax law; however, the deductible foreign loss is limited by the amount calculated in accordance with the applicable foreign tax provisions.

The tax benefit in Austria for losses incurred by foreign group members can be recaptured in several instances. The first relates to dual loss benefits. When the foreign member can receive a credit in future years for the foreign loss against foreign profits in accordance with the rules of applicable foreign tax law – for example, by using a loss carryforward provision – recapture rules apply. As a result, if such losses can be used abroad, the tax base of the group parent will be increased by the amount of losses actually used abroad. The second relates to departures from the group. Should the foreign member cease to be a member of the tax group, the tax base in Austria will be increased in an amount corresponding to the losses previously consolidated in Austria but not yet used against foreign profits.

If the foreign group member ceases to exist because of liquidation or insolvency and definite capital losses are incurred by the parent company, the recaptured amount is reduced by those write-downs that were not tax effective during the period of group membership.

Previously, the group taxation regime applied to subsidiaries resident in E.U. Member States and to subsidiaries anywhere in the world, although in practice, accounting rules made it enormously difficult to integrate a foreign subsidiary into an Austrian tax group. Subsidiaries resident in non-E.U. Member States can qualify as group members only if the country of residence has entered into an agreement on mutual administrative assistance in tax matters with Austria.

Finally, a write-down of participations in the share capital of group members will not be deductible for tax purposes. Previously, this disadvantage had been partially offset by the fact that, for Austrian-resident companies, goodwill acquired by means of a share acquisition was written down. If the acquisition costs of a shareholding exceeded the net capital of the acquired company increased by hidden reserves of non-depreciable assets, the excess amount (capped at 50% of the acquisition costs) was capitalized and depreciated over 15 years. However, depreciation of goodwill no longer applies.

B.E.P.S.: Disallowance of Interest and Royalty Payments

In accordance with international actions to be taken against base erosion and profit shifting, as of March 1, 2014, interest and royalty payments made by Austrian corporations to related parties are no longer tax deductible if, at the level of the receiving entity, such payments are tax exempt or taxed at a rate of less than 10% (also taking into account tax credits), or if, at the level of the beneficial owner, the receiving entity is not the beneficial owner of the interest or royalty payment.

WITHHOLDING TAX ON OUTBOUND PAYMENTS

Dividend Payments

Effective January 1, 2016, dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 27.5% (previously 25%). Dividends paid by an Austrian company to an E.U.-resident parent are exempt from taxation under legislation implementing the P.S.D., if the parent company directly holds a participation in the Austrian subsidiary of at least 10% for a minimum period of one year. If payments are made before the minimum holding period has elapsed, the payment is subject to withholding taxation; the parent company, however, is entitled to a refund once the minimum holding requirement has been met.

In addition, tax must be withheld in cases of suspected abuse according to §94, nr. 2 of the Austrian Income Tax Act ("I.T.A."). In particular, abuse is assumed if the parent company is not actively engaged in business and does not have a number of employees or its own office. In such cases, withheld tax is refunded on application of the parent company provided that the abuse presumption is rebutted.

Under most tax treaties, withholding tax is ordinarily reduced to 15% for portfolio dividends and 5% for non-portfolio dividends. In some cases, withholding tax may be eliminated entirely (*e.g.*, Bulgaria). Austria has over 90 income tax treaties currently in effect, including those illustrated in the following table:

Albania	Algeria	Armenia	Australia
Azerbaijan	Bahrain	Barbados	Belarus
Belgium	Belize	Bosnia & Herzegovina	Brazil

Bulgaria	Canada	Chile	China
Croatia	Cuba	Cyprus	Czech Republic
Denmark	Egypt	Estonia	Faroe Islands
Finland	France	Georgia	Germany
Greece	Hong Kong	Hungary	Iceland
India	Indonesia	Iran	Ireland
Israel	Italy	Japan	Kazakhstan
Kuwait	Kyrgyzstan	Latvia	Liechtenstein
Lithuania	Luxembourg	Macedonia	Malaysia
Malta	Mexico	Moldova	Mongolia
Montenegro	Morocco	Nepal	Netherlands
New Zealand	Norway	Pakistan	Philippines
Poland	Portugal	Qatar	Romania
Russia	San Marino	Saudi Arabia	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Spain	Sweden	Switzerland
Taiwan	Tajikistan	Thailand	Tunisia
Turkey	Turkmenistan	Ukraine	United Arab Emirates
United Kingdom	United States	Uzbekistan	Venezuela
Vietnam			

Capital Gains

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

However, Austria has waived its right to tax capital gains from the disposal of shares under most of its tax treaties as specified in the O.E.C.D. Model Convention.[3]

Royalties

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%; expenses are not deductible. However, under most tax treaties, the withholding tax is reduced or eliminated (*e.g.*, Germany, Poland, Hungary, and Croatia). If the receiving company is resident in an E.U. or E.E.A. Member State, expenses directly connected to the royalty income may reduce the withholding tax base. However, in this case, an increased withholding tax rate of 25% applies to the net base.

Austria has adopted the Interest and Royalties Directive and exempts intra-group

---

3 Paragraph 4 of Article 13 (Capital Gains) of the O.E.C.D. Model Tax Convention on Income and on Capital.

“Given the fact that Austrian tax law does not provide for statutory thin capitalization rules, debt financing has been an attractive method for repatriating profits from an Austrian holding company to its foreign parent company.”

interest and royalties from withholding tax when the recipient is resident in an E.U Member State. Section 99a of the I.T.A. applies to interest and royalty payments made to associated companies of a type listed in the Annex to the Interest and Royalties Directive or their permanent establishments located in an E.U. Member State. In all circumstances, the recipient must qualify as the beneficial owner of the payment.

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

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

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

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

Interest

Interest payments to non-Austrian resident corporations are not subject to Austrian tax.

Given the fact that Austrian tax law does not provide for statutory thin capitalization rules, debt financing has been an attractive method for repatriating profits from an Austrian holding company to its foreign parent company. However, tax authorities have become more restrictive in light of the E.U. Anti-Tax Avoidance Directive (the “A.T.A.D.”).

However, in the case of shareholder loans, special attention is given to proper structuring. Under the general anti-avoidance principles, the interest accruing on the loan may be subject to withholding tax as a hidden distribution of profits if the terms of the loan do not meet the requirements of an arm’s length test.

Other Income

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

OTHER TAX ISSUES

Wealth Tax

Austria does not currently impose a wealth tax on Austrian companies or individuals. Future tax reforms may reintroduce a general wealth tax, which was abolished in 1994. The only wealth tax currently imposed is an annual tax on Austrian real estate.

Anti-Avoidance Legislation

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

However, there is a general anti-avoidance rule that provides for the principle of "substance over form." As a consequence of austerity budgets and international B.E.P.S. measures, in recent years this provision has been applied by the Austrian tax authorities more often and to a wider scope of transactions. Thus, tax planning now yields results that are less predictable.

Foreign Tax Credit

Due to a Double Taxation Directive from the Ministry of Finance, certain items of foreign-source income are exempt from Austrian taxation, including (i) income from immovable property located in a foreign state, (ii) business income attributable to a foreign permanent establishment, and (iii) income derived from building sites or construction or installation projects, if the following requirements are met:

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

The credit method applies to all foreign-source income that is neither exempt from taxation according to the foregoing rule nor subject to a tax treaty. The foreign tax credit is capped at an amount corresponding to the part of the Austrian tax that is attributable to income from sources within the foreign country in question. No "basket" rules exist for the foreign tax credit.

FRANCE

Author
Michel Collet
CMS-Bureau Francis Lefebvre
Paris, France

CORPORATION INCOME TAX – GENERAL

The standard corporation income tax ("C.I.T.") rate in France is 33.33%. However, a 3.3% additional social contribution may apply on the fraction of the C.I.T. that exceeds €763,000 (*i.e.*, where the taxable profits are greater than €2,289,000). The effective tax rate in this case is 34.43%. Lower rates apply to small- and medium-sized enterprises ("S.M.E.'s").

The standard rate will be progressively reduced to 28% by 2020 as follows:

- In 2017, S.M.E.'s will be subject to a 28% rate on all their profits up to €75,000. Profits above this threshold will remain subject to the current 33.33% rate.
- In 2018, companies will be subject to a 28% rate on their profits up to €500,000. Profits above this threshold will remain subject to the current 33.33% rate.
- In 2019, the 28% rate will apply to all profits for companies with revenue below €1 billion, and up to €500,000 of profits for companies with revenues in excess of €1 billion.
- In 2020, all companies will be subject to a 28% rate on all their profits.

Additionally, French President Emmanuel Macron announced during his campaign the intention to further reduce the C.I.T. rate to 25% for all companies.

NET OPERATING LOSSES

Carryforward

Net operating losses ("N.O.L.'s") can be carried forward with no time limit. However, the amount that is offset against the taxable result cannot exceed €1 billion plus 50% of the fraction of the taxable result exceeding €1 billion. Also, the transactions that give rise to the N.O.L. can be examined by the tax authorities in the carryforward year in which it is applied to reduced income.

Carryback

N.O.L.'s incurred by companies subject to C.I.T. can be offset against the taxable result realized in the immediately preceding tax year. Thus, a loss incurred in 2017, for example, can only be carried back and used against taxable income in 2016, with no ability to go further backward. Furthermore, the carryback is now limited to the lesser of €1 billion or the taxable income realized in the immediately preceding tax year. The carryback gives rise to a tax credit, the amount of which is determined by applying the C.I.T. rate of the fiscal year during which the profit was realized to the amount of N.O.L.'s carried back. This tax credit can be (i) reimbursed at the end of the five-year period following the year during which the losses were incurred, (ii) used before that date for the payment of the C.I.T. (but not for the payment of the additional contributions to C.I.T.), or (iii) offered as a guaranty to a credit institution.

PARTICIPATION EXEMPTION OR THE DIVIDENDS RECEIVED DEDUCTION

Dividend distributions received by French corporations, whether French or foreign-sourced, are in principle subject to C.I.T. For fiscal years closing as of December 31, 2015, the dividends received deduction ("D.R.D.") regime has been amended to reflect the recommendations of the O.E.C.D.'s initiative to combat base erosion and profit shifting (the "B.E.P.S. Project") and to comply with the E.U. Parent-Subsidiary Directive ("P.S.D.").

Under the new D.R.D. regime, distributions are 95% exempt from C.I.T. where the following conditions are met:

- The shares are in registered form or deposited with an accredited institution.
- The receiving corporation holds at least 5% of the capital of the distributing company and is the effective beneficiary of the dividends.[1]
- The qualifying 5% share in the capital of the distributing company must be held for at least two years.

Specific rules apply for dividends distributed within corporations filing a consolidated tax return (see **Tax Consolidation** below).

The 5% capital threshold refers only to financial rights as they have recently been defined in French case law.[2] This proves flexible where companies issue preferred stock with increased financial rights and reduced voting rights.

The exemption applies from the first day of the 5% holding, provided that the holding period is ultimately maintained for two years. Failure to maintain the shares for two years will result in a claw-back of the exemption. Late-payment interest along with the applicable C.I.T. must be paid within three months of the date of disposal of the shares. A disposal of shares within the course of a tax-free reorganization is disregarded for D.R.D. purposes.

Only dividends attached to classes of stock with financial and voting rights are eligible for the 95% exemption. However, where the receiving entity holds at least 5% of the financial rights and voting rights (and the two-year holding condition is met with respect to this share), all the dividends received on all classes of shares benefit from the 95% exemption.

The D.R.D. regime applies to dividends and other distributions attached to the shares of stock held by the receiving corporation.

---

1 In accordance with recent French case law, Article 145 1-b of the French tax code has been amended to include both full ownership and bare ownership as qualifying for the 5% capital threshold.

2 C.E. November 5, 2014, decision no. 370650.

Dividends are fully exempt with a 5% add-back of the costs deemed to correspond to management of the stock. N.O.L.'s can be applied against that taxable profit.

The D.R.D. applies to dividends received from foreign subsidiaries without limitation, other than those conditions set forth above. Subject to the application of tax treaties, foreign tax withheld in a source country may be used (no later than five fiscal years after the distribution) as a tax credit against any French withholding tax that may be due upon the further distribution of the dividend to a foreign shareholder of the French company.[3] Otherwise, tax withheld at the source is not recoverable. The 5% add-back is calculated on the gross amount of the dividends received from the foreign subsidiary.

"The law does not outline the definitions of the terms 'valid' commercial purpose and a 'genuine' ownership structure. This could affect holding companies whose activities are strictly limited to the holding of securities."

As of March 1, 2010, distributions from a company established in a non-cooperative country or territory (see **Non-Cooperative Countries and Territories and the Black List** below) are not eligible for the D.R.D., except where the corporate shareholder justifies that its holding is effective and not driven by tax fraud.

In anticipation of efforts against base erosion and hybrid instruments, the D.R.D. is no longer applicable to distributions made on or after January 1, 2015 if the dividend gives rise to a deduction at the level of the distributing company. This provision also complies with the amendment of the P.S.D. on cross-border distributions within the E.U. single market, which prevents the exemption of the dividend at the level of the recipient corporation when the dividend was claimed as a deduction against the profits of the distributing company.[4]

In addition, for fiscal years beginning on or after January 1, 2016, the exemption does not apply to dividends received if the corporate shareholder cannot provide justification that the ownership structure was chosen for a valid commercial purpose reflective of economic reality, and that its main purpose was not obtaining the exemption. If proper justification cannot be shown, the ownership structure is not considered "genuine" for tax purposes and the application of the D.R.D. regime is denied.

The law does not outline the definitions of the terms "valid" commercial purpose and a "genuine" ownership structure. This could affect holding companies whose activities are strictly limited to the holding of securities, especially if their shareholders are residents of non-E.U. states. The case law and the tax guidelines, which are unpublished as of June 15, 2017, will likely aid in the determination of understanding the circumstances in which the interposition of a holding company in an ownership structure will be considered unjustified.

This new anti-abuse provision is aimed at artificial ownership structures with insufficient substance. It is very likely that the real challenge for holding companies will be the addition of a new requirement to assess relevance within the holding chain in addition to relying on the number of employees or the size of the premises. The presence of an autonomous decision-making process at the level of the intermediate holding company is critical in asserting the validity of its commercial purpose.

---

[3] French Administrative Doctrine, BOI-RPPM-RCM-30-30-20-50, September 12, 2012.

[4] Council Directive 2014/86/E.U. amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the case of Parent Companies and Subsidiaries of Different Member States, 2014 O.J. L 219/40.

Last, but not least, for fiscal years closed on or after December 31, 2014, a transfer of qualifying stock to a "*fiducie*," which is the equivalent of a trust under French law, is not treated as a disposal for D.R.D. purposes despite the apparent transfer of ownership. Through the trustee ("*fiduciaire*"), the settlor ("*constituant*") should maintain all its voting and financial rights on the stock. This development allows the use of a *fiducie* for leveraged buyouts ("L.B.O.'s") and proves more flexible and less burdensome than the so-called "double luxco structure," which is not exempt from tax or legal challenges.[5]

TAX CONSOLIDATION

Under §223A *et seq.* of the F.T.C., a French company or a French branch of a foreign company that holds, directly or indirectly (either through other French consolidated companies or, subject to certain conditions, through an E.U.-resident company[6]), at least 95% of the capital and voting rights of other French companies or branches of foreign companies may file a consolidated tax return.

The following conditions must be met:

- All members of the tax-consolidated group must be subject to French C.I.T. and have the same financial year.
- Another French company that is subject to C.I.T. must not hold 95% or more of the consolidating company, either directly or indirectly.[7]
- The parent company must satisfy the 95% minimum holding, directly or indirectly, throughout the entire financial year.
- Adequate tax group elections must be filed in a timely manner.[8]

The consolidating company is liable for C.I.T. on the group taxable result, which is the sum of all members' profits and losses, subject to certain adjustments (*e.g.*, the neutralization of intra-group transactions and distributions). Provided they are paid after the first consolidated fiscal year, intra-group distributions are neutralized. The 3% distribution tax does not apply within a consolidated context (see **The 3% Contribution on Distributions** below).

For dividends distributed during fiscal years beginning prior to January 1, 2016, the D.R.D. 5% add-back (see **Participation Exemption or the Dividends Received Deduction** above) was completely deferred until either the distributing company or the receiving company exits the tax group. For fiscal years beginning on or after January 1, 2016, the deferral of the 5% add-back is replaced by a reduction of the add-back to 1%. These rules also are applicable to dividends received from subsidiaries in the E.U. or E.E.A. that would have been qualified to file a consolidated

5 Amending Finance Law for 2014, no. 2014-1655 of December 29, 2014.

6 Or companies situated in Norway, Iceland, or Liechtenstein.

7 A French company subject to C.I.T. may indirectly hold a 95% participation in the consolidating company, provided it is held through a company not subject to C.I.T. or through companies in which it maintains an interest of less than 95%.

8 The filing deadline matches the deadline for filing C.I.T. annual returns.

return had they been formed in France.[9]

An anti-debt-push-down provision under §223B, known as the "Charasse Amendment," restricts the deduction of interest expense where a member of a tax-consolidated group purchases from its controlling shareholders shares of a company that subsequently becomes part of the same tax-consolidated group. In such a case, the acquiring company must add back part of its interest expense for tax purposes during the year of the acquisition and the following eight years.[10]

Tax consolidation proves to be a powerful tool for L.B.O.'s since it combines consolidation and tax-free distributions.

The French tax consolidation regime has been modified in a favorable way during the last few years, thanks to rulings by the E.C.J. Since 2009, following the E.C.J.'s ruling in the *Papillon* case,[11] a consolidated group may include French subsidiaries indirectly held through a company (or permanent establishment) that is (i) resident in the E.U. or E.E.A. and (ii) subject to C.I.T. without exemption in its country of residence.

Pursuant to E.C.J. case law,[12] the Amended Finance Law for 2014 introduced new provisions allowing the tax consolidation of French sister companies and their subsidiaries (under the conditions explained above) where at least 95% is held, directly or indirectly, by the same E.U.-resident company[13] subject to C.I.T. in its country of residence. In such a case, one of the two top sister companies elects to be treated as the consolidating company.

NON-COOPERATIVE COUNTRIES AND TERRITORIES AND THE BLACK LIST

In order to bolster the fight against tax avoidance, the Finance Amendment Bill for 2009 established a blacklist of non-cooperative countries and territories ("N.C.C.T.'s"). A country or territory is defined as an N.C.C.T. if it meets the following criteria:

- It is not a Member State of the E.U.
- It has been reviewed and monitored by the O.E.C.D. global forum on transparency and exchange of information.
- It has not concluded 12 or more Tax Information and Exchange Agreements ("T.I.E.A.'s").
- It has not signed a T.I.E.A. with France.

---

9 *Groupe Steria SCA v. Ministère des Finances et des Comptes Publics*, Case C-386/14, [2015] E.C.R. I___ (delivered September 2, 2015).

10 Interest expense disallowed under the Charasse Amendment are determined using the following formula: (interest expense of all tax group members) x (acquisition price / average indebtedness of all tax group members).

11 *Société Papillon v. Ministère du Budget, des Comptes Publics et de la Fonction Publique*, Case C-418/07, [2008] E.C.R. I-08947.

12 *SCA Group Holding and Others*, Joined Cases C39-41-13, [2014] E.C.R. I___ (delivered on June 12, 2014).

13 Or in Norway, Iceland, or Liechtenstein.

The N.C.C.T. list is updated annually and, as of June 15, 2016, consists of the following states: Botswana, Brunei, Guatemala, the Marshall Islands, Nauru, Niue, and Panama.

The N.C.C.T. list is subject to modification in accordance with developments concerning the conclusion of new tax treaties and/or the effectiveness of the exchange of information as provided by treaties and T.I.E.A.'s.

In cases where one of these countries is involved, the French tax law provides for an aggravated tax rate, tightened anti-abuse of law provisions, or exclusion from favorable tax regimes. In June 2015, the E.U. published its first list of international tax havens. The list comprises countries that are featured on the blacklists of at least ten Member States. It names 30 territories in total, including: Hong Kong and Brunei in Asia; Monaco, Andorra, and Guernsey in Europe; and a series of Caribbean havens, including the Cayman Islands and the British Virgin Islands.

However, following the Panama Papers leaks, the European Commission announced its intent to reform the national tax blacklists of E.U. Member States by replacing them with a common E.U-wide blacklist. Panama was also added to France's list of N.C.C.T.'s as a response to the leaks.

THE 3% CONTRIBUTION ON DISTRIBUTIONS

As of August 17, 2012, companies that are subject to C.I.T. are also subject to a contribution on the distributions made to their shareholders, whether French or foreign, equal to 3% of the distributed amount. This special contribution, treated as C.I.T. (and not as distribution tax), is not deductible.

S.M.E.'s or collective investment funds, and, under certain conditions, real estate investment trusts ("R.E.I.T.'s"), are not liable for the 3% contribution.

The special contribution applies to dividends and distributions as defined by French tax law. This contribution is not applicable to dividends paid in shares (if the shares are not cancelled[14] within one year by the issuing company). As of January 1, 2015, share buybacks can no longer trigger the 3% contribution, as those transactions now fall within the capital gains tax regime. Before that date, the income resulting from share buybacks could be partially regarded as a distribution. The allocation of profits from French permanent establishments to their foreign parents will trigger the 3% contribution, except where the foreign company is E.U.-resident and the allocated profits are subject to C.I.T. in the E.U. Member State without option or exemption.

This contribution is not applicable within a tax consolidation context. Unused tax treaty foreign tax credits on inbound dividends can be credited against the 3% contribution.

Since its enactment in French tax law, the 3% contribution has been criticized as failing to conform with E.U. law. The tax applies to French corporations that make distributions to an E.U. corporation that is a 95% shareholder. If the 95% shareholder is a French corporation that heads a French consolidated group, an exemption applies to distributions within the group. Also, the fact that the 3% contribution

[14] Through a share buyback program not aimed at purging losses of the company (under §§L225-207 of the Commercial Code).

applies to subsidiaries and not to branches could constitute an infringement of the E.U. freedom of establishment. In February 2015, the E.U. Commission initiated an infringement procedure against France to address these issues.

The Constitutional Council determined on September 30, 2016 that the exemption from the 3% surtax does not comply with the French Constitution because it violates the principle of equality. The difference in tax treatment cannot be justified by sufficient factual or situational variances or by reason of the public interest. As a remedy, the exemption now applies to distributions made by French subsidiaries to their parent company on or after 1 January 2017, regardless of whether the parent company is French or foreign or whether it is resident within or outside the E.U. (under certain conditions), provided the 95% ownership requirement is met.

The Court of Justice of the European Union ("C.J.E.U.") also had to address the 3% contribution. It determined that the 3% contribution does not comply with Article 4 of the P.S.D. in the case of the redistribution by a parent company of dividends received from E.U. subsidiaries. Claims may be brought to the French Tax Authorities ("F.T.A.") to request reimbursement for payment of the 3% contribution if the E.U. corporate recipient of the distribution would have qualified to file a consolidated tax return if it had been established in France (see **Tax Consolidation** above). The F.T.A. has begun to issue refunds.

According to statements made by President Macron, the 3% contribution may be repealed.

WITHHOLDING TAX ON OUTBOUND DIVIDENDS

Under §119 *bis* 2 of the F.T.C., a 30% withholding tax is levied on outbound dividend payments subject to tax treaties (see **Outbound Dividends and Tax Treaties** below). Dividend payments made to N.C.C.T.'s are subject to a withholding tax of 75%.

In comparison, withholding is not required on dividends paid to qualifying E.U. parent companies subject to a 10% ownership test (the "E.U. Directive Exemption") or, where the E.U. parent company is unable to recover French-source withholding tax, subject to a 5% ownership test (the "5% E.U. Exemption"). In both cases, a two-year holding requirement applies.

Also, under certain conditions, withholding tax is not due when distributions are paid to collective investment funds established in the E.U. or in a country with which France has signed a convention on administrative assistance (which is the case with a large number of countries).

Outbound Dividends Within the E.U.

E.U. Directive Exemption

The E.U. Directive Exemption applies if the following tests are met:

- The distributing company is subject to C.I.T. (at the standard rate) in France without exemption.
- The shareholder corporation is an E.U. or E.E.A. resident defined as having its place of control and management in another E.U./E.E.A. Member State.

- The shareholder corporation is incorporated under one of the legal forms listed as an appendix to the E.U. Directive 2011/96/E.U. dated November 30, 2011.
- The shareholder corporation is the beneficial owner of the dividends distributed.
- The shareholder corporation is subject to C.I.T. in its E.U/E.E.A. Member State of establishment, without option and exemption.
- The shareholder corporation holds directly 10% or more of the capital of the distributing company.[15]

The dividend may be paid to an E.U./E.E.A. permanent establishment of an eligible shareholder corporation.

In order to comply with the provisions of the P.S.D., the exemption has been amended to reflect the E.U.-inspired anti-abuse provision already introduced for the French D.R.D. (see **Participation Exemption or the Dividends Received Deduction** above). Thus, for fiscal years beginning on or after January 1, 2016, the E.U. Directive Exemption no longer applies to dividends received if the corporate shareholder cannot provide justification that that the ownership structure was chosen for a "valid" commercial purpose and not with the primary aim of obtaining the exemption.

"If the qualifying shareholder is not taxed on the French-source dividends, as is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or greater interest in the French distributing company."

5% E.U. Exemption

The 5% E.U. Exemption that was provided for in the F.T.A. guidelines[16] published in the wake of the E.C.J. *Denkavit* decision[17] has entered into law.

The following requirements must be met:

- The shareholder must enjoy an exemption regime in its own country of residence. This is to say that the recipient shareholder must not be able to credit the French withholding tax against its own tax.
- The shareholder must be a resident of the E.U. or of Liechtenstein, Norway, or Iceland,[18] 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 (i) constitute 5% of the capital and voting rights of the distributing company, (ii) be in registered shares or be kept by a financial establishment, and (iii) be held for at least two years.

When the above conditions are met, the French withholding tax exemption

---

15 As previously mentioned, the shares must be held for at least two years. However, the E.U. Directive Exemption can be claimed before the expiration of that period.

16 BOI-RPPM-RCM-30-30-20-40, April 1, 2015.

17 *Denkavit Internationaal BV and Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, Case C 170-05, [2006] E.C.R. I-11949.

18 As members of the E.E.A.

automatically applies.

In other words, if the qualifying shareholder is not taxed on the French-source dividends, as is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or greater interest in the French distributing company. If the dividend is taxed in the jurisdiction of residence of the E.U. shareholder, the dividend may still be paid gross if the E.U. qualifying corporate shareholder owns 10% or more of the French distributing company.

One may rely on tax treaty provisions as an alternative to the 5% E.U. Exemption. Several tax treaties provide for zero withholding tax on dividends, including those with Spain, Germany, Japan, and the U.S.

Outbound Dividends and Tax Treaties

Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, ranging generally from 25% to 5%. In addition, some tax treaties provide for zero withholding tax on dividends (see above). Also, some income tax treaties have a narrow definition of dividends that restricts the application of the dividend provision only to distributions that qualify as a dividend under corporate law.[19] Consequently, distributions that are treated as dividends under tax law may not be covered by the "dividend" provision but, instead, for example, may fall under the "other income" provision, leading to a withholding tax exemption in France. An example is an exceptional distribution of reserves. Consequently, to the extent that the other operative provision in the tax treaty applies, withholding tax may not be due. This situation may arise in the tax treaties with the Netherlands and Luxembourg.

As of this writing, France has over 120 tax treaties currently in force and effect with the jurisdictions listed below:

Albania	Algeria	Andorra	Argentina
Armenia	Australia	Austria	Azerbaijan
Bahrain	Bangladesh	Belarus	Benin
Bolivia	Bosnia & Herzegovina	Botswana	Brazil
Bulgaria	Burkina Faso	Cameroon	Canada
Central African Republic	Chile	China	Republic of Congo
Croatia	Cyprus	Czech Republic	Ecuador
Estonia	Ethiopia	Finland	French Polynesia
Gabon	Georgia	Germany	Ghana
Guinea	Hong Kong	Hungary	Iceland
India	Indonesia	Iran	Ireland
Israel	Italy	Ivory Coast	Jamaica
Japan	Jordan	Kazakhstan	Kenya
Kosovo	Kuwait	Latvia	Lebanon
Libya	Lithuania	Luxembourg	Macedonia
Madagascar	Malawi	Malaysia	Mali

[19] CE October 13, 1999, *SA Banque Francaise de l'Orient*, RJF 12/99 #1587.

Malta	Mauritania	Mauritius	Mexico
Moldova	Monaco	Mongolia	Montenegro
Morocco	Namibia	Netherlands	New Caledonia
New Zealand	Niger	Nigeria	Norway
Oman	Pakistan	Panama	Philippines
Poland	Portugal	Qatar	Québec
Romania	Russia	Saudi Arabia	Senegal
Serbia	Singapore	Slovakia	Slovenia
South Africa	South Korea	Spain	Sri Lanka
St. Martin	St. Pierre & Miquelon	Sweden	Switzerland
Syria	Taiwan	Thailand	Togo
Trinidad & Tobago	Tunisia	Turkey	Turkmenistan
Ukraine	United Arab Emirates	United Kingdom	United States
Uzbekistan	Venezuela	Vietnam	Zambia
Zimbabwe			

France has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

CAPITAL GAINS TAX ON SHAREHOLDINGS – EXEMPTION

Gains on the sale of substantial shareholdings ("participations") are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for capital gains tax ("C.G.T.") relief. Such relief is available in the form of an exemption or a reduced C.I.T. rate.

C.G.T. on substantial shareholdings covers gains on the disposal of participations, including shares or interests that the shareholder intends to hold as long-term investments, *viz.*, at least two years. They must be sufficient to provide the shareholder with control of, or significant influence over, the company; these tests are regarded as met with a 10% or greater interest. Stock eligible for the D.R.D. (5% interest) and stock received within the course of a public offering are also eligible. Shareholdings in N.C.C.T.-resident entities cannot qualify.

The exemption applies subject to a 12% add-back, which brings the effective tax rate to 4.13% of the gain, unless N.O.L.'s are available.[20] The 12% costs and charges share is calculated from the amount of exempted gross capital gains (capital losses are not taken into account). Disposals of shares in a listed real estate holding company ("S.I.I.C.," which is the French equivalent of a R.E.I.T.), of which more than 50% of the French assets consist of real estate, are eligible for the application of a 19% reduced C.I.T. rate, *i.e.*, a 19.62% effective tax rate, if the substantial

[20] Where the company is subject to the 10.7% additional contribution, the effective tax rate is 4.56%. However, for dividends received during financial years ending on or after December 31, 2016, the effective tax rate drops to 4%-4.13% due to the repeal of the special contribution on C.I.T.

shareholding requirements are met.[21] Disposal of shares of non-listed real estate holding companies are subject to the standard C.I.T. rate.

Capital gains resulting from the disposal of interests in venture capital funds or companies ("F.C.P.R." or "S.C.R.") that are held for at least five years are eligible for the C.G.T. exemption, but only in proportion to the investments made by the company and funds in qualifying substantial participations; otherwise, a 15% reduced C.I.T. rate applies (*i.e.*, a 15.45% effective tax rate).

For fiscal years closed on or after December 31, 2010, deductions for short-term capital losses incurred upon the transfer of shares held for less than two years to a related party are deferred until the shares are effectively transferred to a non-related party.

OTHER TAX ITEMS

Deductibility of Interest Charges

Interest paid on a debt-financed acquisition of shares is deductible, even if the shareholder qualifies for a participation exemption on dividends (see **The 3% Contribution on Distributions**) and C.G.T. relief (see **Withholding Tax on Outbound Dividends**). This is, however, subject to several interest deductibility limitations.

Also, within a tax-grouping context, an anti-debt-push-down mechanism restricts the deductibility of interest. (See the Charasse Amendment discussed in **Tax Consolidation**, above.)

Interest Rate Test

Only interest paid at an arm's length rate can be considered tax deductible. When paid to an affiliate, interest expenses are tax deductible only within the limit of a rate corresponding to the average annual interest rate granted by credit institutions to companies for medium-term loans (*i.e.*, 2.03% for financial years ending on December 31, 2016). Interest expense paid in excess of this limit are deductible only to the extent that the company establishes that they are arm's length.

However, these provisions are not applicable to interest paid to shareholders that qualify for the participation exemption regime on dividends (see **The 3% Contribution on Distributions**).

Excess interest paid to affiliates under the interest rate test is treated as a distribution eligible for the participation exemption regime on dividends, or it may be subject to withholding tax (pursuant to the tax treaties) with resident lender affiliates. Some tax treaties may deny France the right to tax a deemed distribution where the dividend provision of the tax treaty does not encompass deemed distributions (see, *e.g.*, Luxembourg and the Netherlands).

Anti-Hybrid Rule

In an effort to curb the use of hybrid instruments, France has unilaterally introduced

---

[21] This consists of the 19% tax rate increased by the 3.3% surcharge mentioned under **Corporation Income Tax – General** above. Where the company is subject to the 10.7% additional contribution, this effective tax rate is 21.65%.

an anti-hybrid mechanism. This mechanism disallows interest deductibility in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax that would have been due in France (*i.e.*, at least 8.33% according to the French Parliament, which corresponds to one-quarter of the 33.33% French C.I.T. standard rate[22]). The rate should refer only to the tax regime applicable to the gross income received from France, as opposed to the effective tax rate of the recipient entity. Expenses and losses that reduce the taxable result of the foreign company are not considered if the corresponding income is taxable at a rate of at least 8.33%. The guidelines do not provide for a case in which the recipient entity is itself indebted and serves a debt. The French general anti-avoidance rule should also be considered.

Thin Capitalization

Related-party debt within the scope of French interest limitation rules includes debt extended by the controlling shareholder (either direct or indirect) and sister companies that are under control of the same shareholder ("Affiliates"). A shareholder directly or indirectly holding at least 50% of the capital of the French indebted company, or exercising control over the company's decisions, is regarded as controlling the company for purposes of the thin capitalization rules. Third-party debts that are guaranteed by related parties are assimilated to related-party debt for thin capitalization purposes. However, this extended scope does not apply to debts related to

- bonds offered to the public;
- loans secured by a pledge, if the pledge is (i) over the shares of the borrower (*e.g.*, a parent company gives a pledge on shares of a French subsidiary to guarantee the loan granted by a bank to the subsidiary), (ii) on receivables held by the parent company on its direct subsidiary, or (iii) over securities of a direct or indirect shareholder of the borrowing entity, provided that the entity that grants the pledge and the borrower are members of the same French tax-consolidated group;
- refinancing resulting from the mandatory repayment of pre-existing debt after a change of control of the borrower; or
- loans contracted prior to January 1, 2011 for the purpose of an acquisition of securities, or refinancing contracted prior to January 1, 2011 for loans granted for the purpose of an acquisition of securities.

The test applies to Affiliates only. Two companies are regarded as Affiliates where (i) one holds directly or indirectly a majority in the capital of the other (legal control) or *de facto* controls it, or (ii) both companies are, within the same criteria, under the *de facto* or legal control of a third company.

It is then applied to the allowed fraction of the interest under the interest limitation rules explained above to determine if the interest expense is actually deductible.

Deductions claimed for interest expense will be disallowed when the creditor is an Affiliate and the following three tests are met:

---

[22] Under F.T.A. guidelines, the reference tax rate should account for additional contributions to C.I.T. to which the foreign company would have been subject if resident of France (BOI-IS-BASE-35-50, August 5, 2014).

- 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.
- 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 rules provide for two safe harbors. First, a 1.5-to-1 debt-to-equity ratio safe harbor is applicable. . . . Second, a worldwide group safe harbor applies."

The disallowed interest can be carried forward to offset profits in the following years (up to 25% of the profits before tax, after the deduction of currently allowed related-party interest). The carryover is reduced by 5% each year from the second carryover year on.

The rules provide for two safe harbors. First, a 1.5-to-1 debt-to-equity ratio safe harbor is applicable, as seen above.

Second, a worldwide group safe harbor applies. Under the worldwide group safe harbor, the interest expense deduction will not be limited if the French borrower demonstrates that the disqualified interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group. Related-party debt and reciprocal transactions within the worldwide group should be set aside when computing the debt-to-equity ratio of the worldwide group. The worldwide leverage safe harbor does not allow for the leverage test to be divided by industry within the worldwide group, even though the degree of leverage generally differs from one industry to the next.

Interest exceeding the higher of the above limits is not tax deductible but may be carried forward within certain limits (they are deductible within the limit of 25% of the current income before taxation). Further, the interest deduction is reduced by 5% annually from the second year of the carryforward period. The excess interest is not regarded as a deemed distribution. No withholding tax should apply, especially where the recipient is treaty protected.

Among companies filing a consolidated tax return, the thin capitalization rules are applied at the level of each member on a stand-alone basis. The aggregate of disallowed interest may be deducted from the consolidated tax profit for an amount that does not exceed the difference between (i) the aggregate of the related-party interest paid by companies filing a consolidated tax return to non-consolidated entities and carryovers of pre-consolidation disallowed interest that was deducted during the consolidation, and (ii) 25% of the operating profits of member companies before tax.

Banks and certain financial institutions are excluded from the scope of the new thin capitalization rules. In addition, related-party debts incurred within the course of cash-pooling arrangements or asset-financing transactions involving leases or "credit bail" contracts may not be considered for computation purposes, for the purpose of those activities only.

M&A Context Limitation

As part of the 4th Finance Amendment Bill for 2011, an anti-abuse rule was introduced under §209 IX F.T.C., whereby interest charges incurred in connection with the acquisition of substantial shareholdings in a French subsidiary may be disallowed unless the French acquiring company (or a French permanent establishment of a foreign company) justifies that the following cumulative conditions are met:

- "Decisions related" to the stock of the newly acquired French company are effectively taken in France, by the acquiring company itself or by a parent or a sister company established in France only.
- Where the French acquiring company actually exercises "control or influence," it is effectively exercised in France by the same entities.

The two conditions above must be met either with respect to the shareholding acquisition fiscal year or with respect to the fiscal years relating to the 12-month period following the shareholding acquisition. If the company is not in a position to perform the required demonstration, interest charges must be recaptured until the end of the eighth year following the shareholding acquisition.

This legislation aims to prevent foreign-based groups from using a French holding company to take advantage of the French consolidation regime in claiming a deduction of the interest on the acquisition debt against profits of the French targets. Originally, the bill was aimed only at French targets, but for anti-discrimination purposes, the scope was expanded to include non-French targets.

The safe harbor for decision-making processes within French-only parents or Affiliates proves discriminatory *vis-à-vis* foreign-based groups and may be challenged under E.U. law (on the claim that it is an obstacle to the freedom of establishment) and treaty law (where the treaty includes an article preventing discrimination towards subsidiaries of parent companies established in the country of the treaty partner, comparable with Article 24.5 of the O.E.C.D. Model Tax Treaty).

The limitation does not apply where (i) the fair market value of the acquired shares does not exceed €1 million; (ii) the acquisition is not financed, directly or indirectly, through debt; or (iii) the consolidated debt-to-equity ratio of the group is greater than or equal to the debt-to-equity ratio of the French acquiring company.

General Limitation on Interest Deductibility / Tax Barrier

As of January 1, 2014, only 75% of net financial expenses are deductible if the amount exceeds €3 million. Where the amount of tax-deductible financial expenses (after the application of the interest tax deductibility limitation rules described above) less the amount of the financial profits received equals €3 million or more, 25% of the net amount is not tax deductible. The limitation also applies to third-party debt.

Withholding Tax on Interest – Exemptions

According to §119 *bis* 1 and 125 A III of the F.T.C., a withholding tax is in principle levied on interest paid to a nonresident recipient. However, French domestic tax law provides for several exemptions, resulting in the almost systematic exemption of withholding tax. Three of these exemptions are outlined below, for (i) interest on loans, (ii) interest on bonds, and (iii) interest paid inside the E.U.

In addition, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company. Accordingly, each of the income tax treaties between France and Germany, Austria, the U.K., Ireland, and Sweden provides for zero withholding tax on interest.

Interest on Loans

For loans contracted on or after March 1, 2010, no withholding tax applies to interest paid by a French company to a nonresident company.

Yet, a 75% withholding tax is still applicable where the interest is paid on an account held in an N.C.C.T. (see **Participation Exemption or the Dividends Received Deduction**), unless the debtor justifies that the operations that gave rise to the interest do not principally aim or result in shifting profits to the N.C.C.T.

For loans contracted before March 1, 2010, interest can be paid free of withholding tax where

- the initial lender is a nonresident individual or legal entity established outside of France;
- the loan is documented by an agreement executed before the loan proceeds are transferred to the French company; and
- the loan agreement sets forth the principal, the date of repayment, the interest rate, and any additional remuneration to the lender.

The subsequent sale or assignment of the receivable should not jeopardize the application of the exemption.

Interest on Bonds

Under §119 *bis* 1 of the F.T.C., interest paid to nonresidents on bonds from French issuers is exempt from withholding tax provided that the securities were issued after January 1, 1987. Under §125 A III of the F.T.C., the levy at source is not applicable to interest on bonds ("*obligations*") issued after October 1, 1984 that are paid by a debtor domiciled or established in France, if the beneficial owner of the interest demonstrates that he or she has a fiscal domicile or corporate seat outside the territory of the French Republic, Monaco, or a member state of the so-called "*Zone Franc*." Evidence of the foreign domicile or seat of the beneficial owner must be furnished to the paying agent of the interest. Evidence of the foreign domicile is assumed for bonds converted into euros on or after January 1, 1999. The exemption applies to tradable securities and units in French securitization vehicles ("*fonds commun de créances*").

Interest Paid to a Related E.U. Company

The recipient is an eligible E.U. company that is subject to C.I.T. in its jurisdiction of residence. The "payer" and the "beneficial owner" must be related parties. Parties will be treated as related where (i) the payer 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 payer and the beneficial owner. The ownership interest must be held for at least two years. Payments made before the expiration of the two-year period can be exempted from withholding tax if the shareholder undertakes to hold the ownership interest for at least two years. An E.U.

permanent establishment of an eligible E.U. company can be treated as an eligible party (either as the payer or beneficial owner) as long as the interest is subject to C.I.T. in the E.U. Member State of the permanent establishment. The beneficial owner of the payments must give the payer all required evidence that the tests have been fulfilled.

The exemption includes an anti-abuse provision under which the exemption may be denied where the beneficial owner is controlled directly or indirectly by a non-E.U. corporate shareholder and obtaining the tax benefit is a principal reason for the structure. (See **E.U. Directive Exemption** 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 one such example.

C.F.C. Legislation

Section 209 B is the French counterpart to "Subpart F" of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d'Etat*, struck down §209 B as discriminatory under the French-Swiss Tax Treaty.[23] The *Conseil* found that §209 B indeed amounted to a tax on French business profits of the foreign company, which, in the absence of a permanent establishment in France, was precluded by the income tax treaty applicable between France and Switzerland at that time. In addition, §209 B was clearly at odds with the principle of free establishment protected by the E.C. Treaty. The French controlled foreign corporation ("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 they are distinct from their shareholders (*viz.*, companies, partnerships, associations, etc.). They also include trusts.

The holding threshold increased from 10% to "more than 50%" for the foreign entity to be treated as a C.F.C. under §209 B. However, that threshold drops to 5% if 50% of the legal entity is held directly or indirectly by other "French enterprises" that control or are under the control of the first French company.[24] In the case of related enterprises, the 5% test applies even if the related enterprise is not established in France.

The new provisions do not replace the current anti-abuse provision, pursuant to which an interest held by "sister entities" (whether French or foreign) is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is subject to C.I.T. at a rate below

---

23 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.

24 Control means (i) holding directly or indirectly the majority of the share capital of the "controlled" entity, (ii) having the majority of voting rights, directly or indirectly, or (iii) having the power of decision. In addition, the control test is met where a company is *de facto* dependent on the other one, due, for example, to commercial ties.

16.66% (*i.e.*, 50% of the French C.I.T.).

Section 209 B provides an E.U. exclusion. The C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a "wholly artificial arrangement, set up to circumvent France tax legislation." This provision follows the case law developed by the E.C.J., particularly *Cadbury Schweppes*.[25] In the *Cadbury Schweppes* case, the E.C.J. decided that the C.F.C. was not artificially established when it participated in economic activity in the host country with the required substance (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 to C.F.C.'s established in non-E.U. countries.

Where a C.F.C. derives passive income from financial activities or the management of intangibles, the exclusion applies unless (i) the passive income comprises more than 20% of the profits of the C.F.C., or (ii) more than 50% of the profits of the C.F.C. are derived from financial activities, the management of intangibles, and services rendered to affiliates. In such a case, the French taxpayer must demonstrate that using the foreign entity or enterprise does not primarily result in locating profits in a low tax jurisdiction.

As of March 1, 2010, for C.F.C.'s established in an N.C.C.T., the trade and business exclusion does not apply unless the taxpayer can justify the effectiveness of the business carried out and comply with the 20% and 50% ratios.

"The French taxpayer must demonstrate that using the foreign entity or enterprise does not primarily result in locating profits in a low tax jurisdiction."

If the C.F.C. does not qualify for either the E.U. or the Trade or Business Exclusions, the French taxpayer may still prove that the establishment of the C.F.C. does not primarily result in relocating profits to low tax jurisdictions to avoid the taxation of the C.F.C.'s profits in France.

In response to a 2002 decision by the *Conseil d'Etat*, a new law provides that profits derived from the legal entity established or formed abroad and attributed to the French company under §209 B would be treated as "deemed distributions." The F.T.A. contends that under these conditions, conflict with the tax treaties would be eliminated.

N.O.L.'s of the French company are available to reduce the taxable income arising from the attribution of profits from a C.F.C. Moreover, tax credits of the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

Transfer Pricing

The arm's length principle applies to transactions between related parties. France follows the O.E.C.D. Guidelines.

Transfer pricing documentation is mandatory in France for

---

[25] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995; see also *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*, Case C-264/96, [1998] E.C.R. I-04695, and guidelines issued by the F.T.A. dated January 16, 2007 (4-H-1-07).

- French companies with a gross annual turnover or gross assets equal to or exceeding €400 million;
- French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €400 million threshold;
- French parent companies that directly or indirectly own at least 50% of companies meeting the €400 million threshold; or
- worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €400 million threshold within the perimeter).

The documentation – corresponding to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European commission – must include (i) general information about the group and its subsidiaries, known as the "master file," and (ii) detailed information on the French audited company (*i.e.*, a description of its activities and transactions, including a presentation of the applied transfer pricing method), known as the "country-specific file." This documentation must be presented to the F.T.A. when the company is audited.

If the company fails to provide the documentation, a fine amounting to the greater of €10,000 or 5% of the adjusted profits may apply.[26] For tax audits realized on or after January 1, 2015, the fine may be as much as 0.5% of the amount of the transactions for which no documentation has been presented.

Since 2014, the following entities must also annually electronically file a simplified transfer pricing form within the six-month period following the filing of their tax return:

- French companies with a gross annual turnover or gross assets equal to or exceeding €50 million
- French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €50 million threshold
- French parent companies that directly or indirectly own at least 50% of companies meeting the €50 million threshold
- Worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €50 million criteria within the perimeter)

Where transactions carried over from affiliated companies involve an amount below €100,000 per type of transaction, the company does not have to file the simplified transfer pricing documentation.

The law does not provide a specific penalty for the failure to file. Therefore, the general penalty of €150 per document provided by Article 1729 B of the F.T.C. should apply for each document that is not filed. In cases where some items are missing or inaccurate in a document, the penalty is equal to €15 per item with a minimum penalty of €60.

[26] The actual rate will depend on the behavior of the company.

For companies not subject to the mandatory transfer pricing documentation, the F.T.A. may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company, and details regarding the activities of the nonresident affiliated companies and the tax regime applicable to them.

In order to avoid uncertainty, taxpayers may want to reach an advance transfer pricing agreement with the F.T.A. The advance pricing agreement could be unilateral, bilateral, or multilateral. The French program proves to be efficient and pragmatic. Finally, in accordance with the O.E.C.D.'s B.E.P.S. Action Plan, the Finance Bill for 2016 introduced CbC Reporting obligations for French companies that (i) control foreign subsidiaries or have permanent establishments overseas, and (ii) have a consolidated turnover exceeding €750 million.

This disclosure obligation concerns

- the activities and places of activity of the entities in the group; and
- information about profit splitting among these entities.

According to Article 223 *quinquies* C of the F.T.C., this new measure also applies to international groups that meet the turnover threshold and have either a French permanent establishment or a French subsidiary, unless they are subject to a similar obligation in their respective country of residence. *A contrario*, French entities that are held by foreign companies subject to a similar obligation in their respective country of residence are not subject to CbC Reporting in France.

These mandatory filing requirements aim to provide tax authorities with an overview of the states where expenses, income, and profits are located, and are likely to support future reassessments.

The reporting obligations must be fulfilled within 12 months after the closure of the annual accounts.

The new CbC Reporting obligations apply to fiscal years beginning on or after January 1, 2016. Failure to comply with the requirements will trigger the imposition of a penalty which cannot exceed €100,000 per default.

A European directive[27] provides for a similar mechanism at the E.U. level. Under the directive, the mandatory exchange of information between the European tax administrations is extended to include the automatic exchange of information on the CbC Report.

Financial Transaction Tax

Introduced by former French President Nicolas Sarkozy as a push toward an E.U.-wide tax, the Financial Transaction Tax ("F.T.T.") imposes participation by the financial industry in the restoration of public accounts. This 0.1% tax applies to acquisitions of listed stock issued by companies whose legal seat is in France with a market capitalization above €1 billion on January 1 of the year during which the

[27] Council Directive 2016/881/E.U. amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2016 O.J. L 146/8.

acquisition takes place.[28]

Taxable transactions involve French-issued equity securities, as defined above, and securities that may give rise to equity rights (for example, preferred stocks, convertible bonds, and any other bonds that may give rise to equity rights).

Acquisitions of options and futures are not taxable. With tax being due at the time the stock is delivered at maturity (if not issued by the company), double taxation may arise.

The F.T.T. also applies to instruments equivalent to French-listed stock or stock rights even if issued by another issuer under a foreign law (*e.g.*, American depository receipts).

The term "acquisition" includes a transfer of ownership through a purchase, exchange, contribution, or exercise of an option or through a futures contract.

To be subject to the F.T.T., the stock or equivalent instruments would be negotiable on a regulated market in France, the E.E.A., or on some limited non-E.U. regulated markets, such as in Switzerland (Bourse Suisse) and Montréal (Bourse de Montréal Inc.). The N.Y.S.E. is not included. Stocks listed on a multilateral trading system are also outside the scope of the tax.

After ten Member States including France, Belgium, and Germany implemented an F.T.T., the question arose as to whether an E.U.-wide F.T.T. would be implemented. A growing number of Member States are resisting the proposal over concerns regarding competitiveness. The project is controversial, especially in the context of Brexit, since the U.K. is one of its major opponents. A meeting to address the issue was planned for after June 15, 2016.

Transfer Taxes

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares, the following rates generally apply:

- As of August 1, 2012, a fixed tax rate of 0.1% applies to transfers of stocks issued by a French S.A., S.C.A. or S.A.S. – except if the entities qualify as real estate holding companies for tax purposes (intra-group transactions can benefit from a transfer tax exemption).
- Transfers of units issued by French partnerships, the capital of which is not divided into stocks – except if the entities qualify as real estate holding companies for tax purposes – are subject to a fixed transfer tax rate of 3%. A relief equal to €23,000 divided by the total number of units issued by the entity is applied to the taxable value of each unit.
- Transfers of shares issued by French real estate holding companies – irrespective of their legal form – are subject to a 5% transfer tax.
- Transfers of shares issued by foreign-deemed-French real estate holding companies are also subject to a 5% transfer tax. In addition, the transfer should be documented and executed by and before a French notary, unless

[28] This could affect about 100 French companies.

the documentation is executed in France by the parties or their representatives.

Regarding the sale of assets, the following rates generally apply:

- Transfers of real property assets located in France are subject to tax at a rate of 5.09% or 5.81%.[29] A 0.6% additional tax applies to the sale of assets allocated to a commercial purpose (*e.g.*, offices, retail, or storage) that are located in the Île-de-France region (and in some cases, such transfers may be subject to V.A.T. instead).
- A progressive tax rate applies for transfers of business as going-concerns ("*fonds de commerce*") or goodwill: (i) 0% for the fraction of the transfer price below €23,000, (ii) 3% for the fraction between €23,000 and €200,000, and (iii) 5% for the fraction exceeding €200,000.

B.E.P.S. and France

France is one of the founding members of the O.E.C.D. and is highly involved in the O.E.C.D.'s work relating to the B.E.P.S. Project. Soon after the publication of the O.E.C.D. report, "Addressing Base Erosion and Profit Shifting," in February 2013, the Parliament Commission of Finances released a report on the same topic, which reaffirmed the prevention of tax evasion and tax fraud as a priority for the French government and formally endorsed the B.E.P.S. Project. The French government itself also actively encourages the E.U. to act on these issues.

A report relating to the taxation of the digital economy, ordered by the French Ministry of Economy and Finance, was published in January 2013. In a related press release, the French government stated its intention to take more decisive action in the G-20, the O.E.C.D., and the E.U., in order to adapt international tax rules to the reality of the digital economy and, in particular, to seek a more efficient definition of "permanent establishment." The report especially raised the possibility of tax on the digital economy in relation to personal data. The French government hopes that this proposition will be further analyzed.

In particular, the French government places high priority on the elimination of inappropriate double nontaxation, the reinforcement and effectiveness of anti-avoidance rules, and addressing profit shifting issues that arises in the context of the digital economy. B.E.P.S. issues are regularly debated in commissions and assemblies of French Parliament, and several legal provisions have been introduced in recent finance bills. For example, the 2013 to 2016 finance bills have included provisions relating to

- the obligation of tax professionals to disclose tax optimization schemes to the F.T.A.;
- the modification of the abuse-of-law provisions from an *exclusively* tax-driven test to a *principally* tax-driven test;
- the application of a penalty for tax professionals who advise the use of abusive tax schemes; and
- the limitation of the D.R.D. regime (see **Participation Exemption or the**

[29] The tax rate applicable depends from the location of the asset.

Dividends Received Deduction above) to dividends issued from profits resulting only from activities subject to C.I.T.

The French Constitutional Court dismissed these provisions, as they do not in conform with the French Constitution on various grounds. However, other provisions have been successfully enacted, including

"Experience shows that tax auditors do not hesitate to retain positions inspired by the current work of the O.E.C.D. on B.E.P.S., even if it is not compliant with the current tax law."

- the limitation of the D.R.D. regime so that it excludes dividends that have been deducted when determining the distributing company's taxable income,[30] or when the ownership structure cannot be considered genuine because it is not justified by a valid commercial reason (see **Participation Exemption or the Dividends Received Deduction** above);
- the anti-hybrid mechanism, which disallows interest in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax which would have been due in France (see **Deductibility of Interest Charges** above); and
- the annual CbC Reporting requirements for French companies controlling foreign entities or having permanent establishments overseas (see **Transfer Pricing** above).

Certainly, the French government is highly involved in the B.E.P.S. Project at the level of the O.E.C.D., as well as at the level of the E.U., and it is expected to be a pioneer in implementing new regulations that may be proposed to combat B.E.P.S. within either organization, or at a federal level.

On the ground, experience shows that tax auditors do not hesitate to retain positions inspired by the current work of the O.E.C.D. on B.E.P.S., even if it is not compliant with the current tax law. Consequently, it appears that France has already started the process of adopting some anti-B.E.P.S. measures unilaterally. Such action gives rise to questions of potential double taxation unless a multilateral policy is adopted.

In any case, implementation of the B.E.P.S. Action Plan continues within the E.U. Member States. Additionally, a project known as the Anti-Tax Avoidance Directive ("A.T.A.D."), directly inspired by the B.E.P.S. Project, is currently being discussed by the Council of the European Union.

The European Parliament passed a resolution on June 15, 2016 to move forward with the A.T.A.D., approving recommendations made by the Economic and Monetary Affairs Committee in May 2016. The proposal builds on the principle that tax should be paid where profits are made. It includes legally-binding measures to block the methods most commonly used by companies to avoid paying tax. It also proposes common definitions of terms such as permanent establishment, tax havens, transfer prices, royalty costs, patent boxes, and letterbox companies. The main measures relate to

- a general interest limitation rule restricting the tax deductibility of net borrowing costs (all deductible borrowing costs minus taxable financial incomes) to 20% of the taxpayer's E.B.I.T.D.A.;
- an anti-hybrid general rule denying the tax deductibility of an expense in the

[30] Transposition of Council Directive 2014/86/E.U. of July 8, 2014, *supra* note 4.

state of the beneficiary when it is also considered a tax-deductible expense in the source state;

- a "switch-over" clause substituting a tax credit for low-taxed foreign incomes (less than 15%) in place of an exemption;
- an exit tax for the transfer of assets under certain conditions; and
- a C.F.C. rule where passive income or income derived from "non-genuine arrangements implemented for a tax purpose" received by permanent establishments and foreign subsidiaries located in a low-tax jurisdiction would be included in the taxable basis of the parent company.

The A.T.A.D. would oblige E.U. Member States to conform their domestic legislation with A.T.AD. provisions. This reality may trigger difficulties for certain countries, France included, which have already implemented comparable but not totally similar anti-abuse provisions regarding, *inter alia*, C.F.C. rules and exit taxation.

ITALY

Author
Luca Rossi
Facchini Rossi & Soci
Milan, Italy

CORPORATION INCOME TAX RATE

As with any Italian-resident company, an Italian-resident holding company is subject to corporation income tax ("I.R.E.S.") levied on the worldwide income of the company at a flat rate of 24%, as provided in the Income Tax Code ("I.T.C.").[1]

A regional tax on productive activities ("I.R.A.P.") also applies to the net value of production performed in Italy. This tax is imposed at the general rate of 3.90%.[2] Higher rates are applicable to banks and other financial institutions (4.65%) and to insurance companies (5.90%). In addition, different regions of Italy may provide for a 0.92% variation of the abovementioned rates.[3]

It should be noted that a holding company that is legally classified as an Italian fixed capital investment company (*i.e.*, a *società di investimento a capitale fisso*, or "S.I.C.A.F.") is subject to the tax regime applicable to undertakings for collective investment (see **The Automatic Exchange of Information** below).

DIVIDEND EXEMPTION

Domestic Dividends

In general, the I.T.C. provides for a 95% exemption with regard to dividend distributions received from a domestic Italian company, whereby no withholding tax is imposed and the effective tax rate is 1.2%.[4] There are no minimum ownership or holding period requirements.

For companies adopting I.A.S./I.F.R.S. accounting, profits received from shares or other financial assets qualifying as "held for trading" are fully taxable.[5] These companies must determine the positive and negative components of their tax base

---

1 Presidential Decree dated December 22, 1986, n. 917. Pursuant to Article 1 (61-65) of Law n. 208 of December 28, 2015, as of 2017 (i) the corporation income tax rate has been reduced from 27.5% to 24%, and (ii) a 3.5% surtax became applicable to banks and financial institutions (including holding companies of banks and financial institutions but excluding management companies of undertakings of collective investments).

2 Legislative Decree dated December 15, 1997, n. 446.

3 Article 16 of Legislative Decree n. 446 of December 15, 1997, as amended by the Law Decree n. 66 of April 24, 2014, converted into Law n. 89 of June 23, 2014.

4 Article 89(2) I.T.C. Pursuant to Article 1 (62) of Law n. 208 of December 28, 2015, as of 2017, the corporation income tax rate has been reduced from 27.5% to 24%. Therefore, the effective tax rate on dividends is 1.2% (0.05 x 0.24 = 0.012).

5 Article 89(2-*bis*) I.T.C.

"The 95% exemption is also applicable to foreign-source dividends provided that the payment is not deductible by the payer in its country of residence. . . . Full taxation applies only to Blacklist dividends."

according to I.A.S./I.F.R.S. criteria, as the accounting standards prevail over the ordinary I.T.C. rules (known as the "Derivation Principle").

When applying the Derivation Principle, the timing accrual principle and the qualification and classification criteria provided by the I.A.S./I.F.R.S. accounting methods are relevant in the calculation of the taxable base. The same principle does not apply to the evaluation and quantification criteria stated by the I.A.S./I.F.R.S. The Derivation Principle has also been extended to companies drawing up their financial statements pursuant to the Italian Civil Code and Italian generally accepted accounting principles ("G.A.A.P"), with few exceptions.[6]

Foreign Dividends

According to Article 89(3) I.T.C., the 95% exemption is also applicable to foreign-source dividends provided that the payment is not deductible by the payer in its country of residence. Nondeductibility must be stated by the foreign company in a declaration or must result from other objective evidence.

Dividends derived by Italian companies from subsidiaries resident in a country or territory characterized as having a privileged tax regime for controlled foreign company ("C.F.C.") purposes (a "Blacklist" jurisdiction, as defined in **C.F.C. Legislation** below) are fully taxable, unless income has been already taxed in the hands of the Italian recipient under the applicable C.F.C. rules[7] or a favorable ruling is obtained from the Italian tax authorities.[8] To receive a favorable ruling, the taxpayer must demonstrate that the purpose of the investment was not to obtain the benefits of a preferential tax regime (*i.e.*, "Condition 2" of the C.F.C. legislation, as defined in **C.F.C. Legislation** below).[9] Effective 2015, the advance ruling is no longer mandatory, provided that Condition 2 can be proved during a tax audit. Where an advance ruling has not been requested or a positive ruling was not obtained, dividends from Blacklist-resident entities must be disclosed on the relevant tax return.[10]

Dividends corresponding to profits already taxed in the hands of an Italian-resident controlling company under the C.F.C. rules are not taxed again upon actual receipt (see also **C.F.C. Legislation** below).

Full taxation applies only to Blacklist dividends derived directly from a participation in a Blacklist-resident subsidiary, or indirectly through a controlled foreign subsidiary in a non-Blacklist country with Blacklist-resident participations.

---

6 See Article 83, I.T.C. as recently modified by Article 13-*bis*(2) of the Law Decree n. 244 of December 30, 2016.

7 In this case, a foreign tax credit will be available for taxes paid on C.F.C. income.

8 See **C.F.C. Legislation** below.

9 The Italian shareholder may also be exempt from the application of the C.F.C. rules if the nonresident subsidiary carries out an effective industrial or commercial business activity in the Blacklist jurisdiction (*i.e.*, "Condition 1" of the C.F.C. legislation, as defined in **C.F.C. Legislation** below). However, under Condition 1, dividends from Blacklist countries are fully taxable and a foreign tax credit will be available for tax paid on the income of the Blacklist subsidiary (see Article 47 I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015).

10 Article 89(3) I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015.

PARTICIPATION EXEMPTION FOR GAINS

The I.T.C. provides for a 95% exemption regime for gains derived from the sale of shares of a subsidiary. According to Article 87 I.T.C., the exemption applies to the disposal of participations in both Italian and foreign subsidiaries.

Several conditions must be met to qualify for the exemption:

- Shares in the subsidiary must have been held for an uninterrupted period of 12 months prior to disposal. In measuring the holding period of shares acquired over time, a "Last-In, First-Out" rule applies; direct tracing is not permitted.
- The participation must be classified as a fixed financial asset on the shareholder's first balance sheet reflecting the beginning of the holding period for the shares.
- In the three fiscal years preceding the disposal of the participation, the subsidiary must be tax resident in Italy or in a jurisdiction that is not a Blacklist country or territory (see also **C.F.C. Legislation** below). If the company is resident in a Blacklist jurisdiction, the shareholder may request a ruling from the Italian tax authorities verifying that the purpose of the investment was not to obtain the benefits of a preferential tax regime. As of 2015, an advance ruling is no longer mandatory provided that this condition can be proven during a tax audit. Where an advance ruling has not been requested or a positive ruling was not obtained, capital gains from Blacklist-resident entities must be disclosed on the relevant tax return.[11]
- The subsidiary must have been engaged in an active business since the beginning of the third financial year preceding the sale of the participation (unless its shares are traded on a stock exchange).

Several conditions apply to the foregoing tests. Under the anti-avoidance rules, a company is deemed not to be carrying out an active business if the predominant asset is real estate, as reported on a company's balance sheet. Where a subsidiary is a holding company, the law requires that tests regarding tax residence and business activity be applied at the level of the subsidiary operating companies. Where the participation exemption applies to a gain, only a portion of costs related to the sale is deductible, equal to the percentage of the gain that is taxable, *viz.*, 5%.[12]

D. Interest Deduction

Finance Act 2008 has completely redefined the interest deduction regime for companies subject to I.R.E.S.

The new regime, in general, provides as follows:[13]

- Interest expense is fully deductible in each tax period for an amount equal to interest income.

---

[11] *Id.*, Article 87(1).

[12] *Id.*, Article 86(2)

[13] See *id.*, new Article 96.

- The excess amount of interest expense can be deducted subject to a cap of 30% of an amount substantially corresponding to earnings before interest, taxes, depreciation, and amortization, as measured in the borrower's profit and loss statement. As of 2016, dividends received from non-Italian resident controlled companies can be included in E.B.I.T.D.A.[14]

- The amount of interest expense that exceeds the 30% limit is, therefore, not deductible in the tax period incurred, but may be carried forward indefinitely until it can be absorbed in a year when sufficient E.B.I.T.D.A. exists.

- The excess E.B.I.T.D.A. generated in each fiscal year may be carried forward and used to increase the E.B.I.T.D.A. of the following periods.

While banks and insurance companies, along with their holding companies and certain other financial institutions, are excluded from the interest deduction regime, it does apply to "industrial holding companies," *i.e.*, companies whose main business consists of holding participations in other entities that do not carry on lending activities or financial services to the public.[15] Industrial holding companies are likely to be penalized by these provisions. Although, if they participate in domestic consolidation rules (see **Group Consolidation**), the excess interest expense of the holding company can be used to reduce the consolidated tax base generated by other associated companies, if and to the extent that such other group companies report E.B.I.T.D.A. not used to support their own deductions. This rule also applies in the case of interest expense carried forward by a company, provided it has been generated during the period of fiscal consolidation.

Separate specific rules apply to banks and insurance companies.

In the past few years, the deductibility of interest incurred in connection with merger-leveraged buyout acquisitions has been challenged by the Italian Tax Authorities based on anti-abuse rules or due to a lack of connection with the activities of the target.

In Circular Letter n. 6/E of March 30, 2016, the Italian Revenue Agency clarified that, as a general principle, interest on an acquisition loan may be deductible if

- the acquisition debt is functionally connected to the leveraged acquisition, and therefore, the deductibility of interest borne on loans granted by third parties should not be challenged; or

- the leveraged transaction is not considered abusive, *i.e.*, based on specific circumstances, it cannot be demonstrated that the operation is intended to obtain a tax advantage that is contrary to the spirit and objectives of the law; an example of an abusive transaction is a releveraging transaction in the absence of a change of control.

MINIMUM TAXABLE INCOME FOR NON-OPERATING COMPANIES

Specific anti-avoidance rules apply to non-operating companies and non-operating

[14] *Id.*, Article 96(2), as modified by Article 4 of Legislative Decree n. 147/2015.

[15] *Id.*, Article 96(5).

permanent establishments in Italy. Under Article 30 of the Law dated December 23, 1994, n. 724, an entity is deemed to be a non-operating company when the sum of its turnover, increase in inventory, and revenue (as reported on its profit and loss statement) is lower than a specified base. The base is the sum of the following items: (i) 2% of the total value of participations in resident and nonresident companies, bonds, other financial instruments, and financial credits; (ii) 4%-6% of the value of real estate and ships owned or leased by the company; and (iii) 15% of the value of other fixed assets. The calculation is made on the average values over a three-year period (*i.e.*, the tax period concerned and the two preceding periods).

When a company is a non-operating company under the foregoing definition, it is taxed at a rate of 34.5% on minimum income.[16] Minimum income is calculated by applying a deemed return to the assets mentioned above. The deemed returns are (i) 1.50% of participations, other financial instruments, and financial credits; (ii) 4.75% of real estate values (reduced to a 3%-4% rate for residential real estate assets and offices); and (iii) 12% of other fixed assets.

A non-operating company may attempt to demonstrate to the Italian tax authorities that specific facts and circumstances prevented it from achieving the minimum turnover and thereby receive a ruling to qualify for the exception. Where an advance ruling has not been requested or a positive ruling was not obtained, the taxpayer can disclose the existence of such conditions on the relevant tax return.[17] There are also certain automatic exclusions from the scope of the general rule. Finance Act 2008 has increased the number of these exclusions, notably for

- companies in the first year of activity;
- companies whose shares are traded on a stock exchange, as well as the subsidiaries and controlling shareholders of such companies;
- companies that have had at least ten employees in the two preceding fiscal periods;
- companies whose value of production, as measured on the profit and loss statement, is greater than the total value of assets reported on the balance sheet;
- companies holding participations in subsidiaries that are considered "operating" companies or that have obtained a positive ruling; and
- companies in insolvency proceedings.

Following the amendments made by Article 2 of Law Decree n. 138 of August 13, 2011, the foregoing provisions are also applicable to companies that have (i) incurred fiscal losses for at least five consecutive tax years, or (ii) incurred fiscal losses for four out of the five years of assessment and in one year have reported income that is lower than the minimum income, as determined in the manner described above. Beginning in the sixth consecutive tax year, those companies will be deemed to be non-operating companies even though they do not meet the usual requirements to

---

[16] A surtax of 10.5% is applicable. See Article 2(36-*quinquies*) of Decree Law n. 138 of August 13, 2011.

[17] Article 30 of Law n. 724/1994, as modified by Article 7 of Legislative Decree n. 156 of September 24, 2015.

do so provided by Article 30(1) of the Law dated December 23, 1994, n. 724.

ALLOWANCE FOR CORPORATE EQUITY

In order to encourage companies to strengthen their financial structures by using equity rather than debt, Article 1 of Law Decree n. 201 of December 6, 2011 introduced the Allowance for Corporate Equity ("A.C.E."), whereby a notional return on the increase in equity generated after 2010[18] may be deducted from total net income if it is derived from capital contributions and the retention of earnings. The amount of A.C.E. that exceeds the net taxable income of the year can be carried forward and used to offset the net taxable base of a subsequent tax period, or it can be converted into a tax credit equal to 24% of the notional yield to offset (in five equal annual installments) the I.R.A.P. due for each tax year.

Ministerial Decree of March 14, 2012 (hereinafter "the Decree") contains the operative provisions of this rule. The A.C.E. applies as of the tax year in which December 31, 2011 falls. The benefit may be claimed by

- companies resident in Italy, as indicated by Article 73(1)(a) I.T.C.;
- state and private entities other than companies, as well as trusts resident in Italy, whose main or exclusive objective is to carry out a commercial activity, as indicated by Article 73(1)(b) I.T.C.;
- Italian permanent establishments of nonresident companies and entities, as indicated by Article 73(1)(d) I.T.C.; and
- individuals, S.N.C.'s, and S.A.'s regulated by ordinary accounting rules.

The A.C.E. is determined by applying a given percentage rate to the net increase in equity, which in turn is calculated as the excess of the equity book value at the end of the year over the equity book value resulting from the balance sheet as of December 31, 2010.[19] The increase in equity book value attributable to the increase in retained earnings for the year is not considered.[20]

In order to determine the net increase in equity, Article 5(2) of the Decree states that the following items must be taken into account:

- Cash contributions paid by existing or new shareholders
- The shareholders' unconditional relinquishment of an obligation of the company and the release of an obligation upon the underwriting of a new issue of shares
- Income accumulated, with the exception of income accumulated in non-available reserves[21]

The net increase in any particular year cannot exceed the value of the net equity

---

[18] Article 1(2) of Law Decree n. 201 of December 6, 2011, as recently modified by Article 7(1) of Law Decree n. 50 of April 24, 2017.

[19] *Id.*, Article 1(5).

[20] Article 4 of the Decree.

[21] See *id.*, Article 5(5) for the definition of "non-available reserves."

at the end of that year.[22] Moreover, for entities other than banks and insurance companies, the net increase must be reduced by an amount equal to the increase of non-equity securities from the fifth preceding year.[23]

In computing the net increase in equity, Article 5(3) of the Decree provides that decreases in equity through any type of distribution to a shareholder must be taken into account (for instance, through dividend distributions or equity reductions).

For tax year 2016, the notional deduction is 4.75%.[24] For the 2017 tax year, the notional deduction will be 1.6%, and from the 2018 tax year onwards the rate will be 1.5%.[25]

The so-called "Super-A.C.E." regime aimed at listed companies has been repealed.

Specific rules are provided for companies participating in a group consolidation[26] and for companies opting for the "transparency regime" under Articles 115 and 116 I.T.C.[27]

Article 10(3) of the Decree provides specific anti-avoidance rules, especially for companies belonging to a group.

GROUP CONSOLIDATION

After the introduction of the participation exemption regime, holding companies cannot reduce income through unrealized losses in participations. However, group consolidation is permitted. Two consolidation regimes exist. One is known as the domestic consolidation regime,[28] and the other is the international or worldwide consolidation regime.[29]

Domestic Consolidation

For the purpose of the domestic consolidation regime, a group of companies is comprised of a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two factors exist. First, the common parent must, directly or indirectly, have more than 50% of the voting rights at the subsidiary's general shareholders' meeting. Second, the common parent must, directly or indirectly, be entitled to more than 50% of the subsidiary's profits. The "de-multiplier effect" must be considered in both cases.

---

[22] *Id.*, Article 11.

[23] Article 1(6-*bis*) of Law Decree n. 201 of December 6, 2011, as modified by Article 1(550) of Law n. 232 of December 11, 2016.

[24] Article 1 of Law Decree n. 201 of December 6, 2011, as modified by Article 1(137) of Law n. 147 of December 27, 2013.

[25] Article 1(3) of Law Decree n. 201 of December 6, 2011, as recently modified by the last version of Article 7 of Law Decree n. 50 of April 24, 2017, as amended by the Italian Parliament on June 15, 2017.

[26] Article 6 of the Decree.

[27] *Id.*, Article 7.

[28] Article 117-129, I.T.C.

[29] *Id.*, Article 130-142.

Under certain circumstances, a nonresident company may participate in a domestic consolidation as the common parent of the group. First, the foreign parent must be a resident in a country that has a tax treaty in effect with Italy. Second, it must carry out business activities in Italy through a permanent establishment. Legislative Decree n. 147 of September 14, 2015 introduced a "horizontal" tax consolidation regime. With effect from 2015, this regime allows a parent entity that is resident in an E.U. Member State or E.E.A. Country that has signed an agreement with Italy allowing the effective exchange of information to designate an Italian-resident subsidiary or permanent establishment as a "consolidating" entity. The consolidating entity may then form a single fiscal unit with another direct or indirect subsidiary of the same parent company. Legislative Decree n. 147 also introduced legislation whereby Italian permanent establishments of E.U./E.E.A. companies may form a consolidated fiscal unit with other Italian-resident companies of the same group.

"Italian law allows for worldwide consolidation where an Italian-resident company controls one or more nonresident companies."

The domestic consolidation regime only applies when an election has been made by the common parent and the participating controlled subsidiaries; all subsidiaries are not required to participate in the regime. Once an election is made, the domestic consolidation is effective for three tax periods. If the requisite degree of control in a subsidiary is relinquished during this time, that subsidiary no longer participates.

The domestic consolidation regime works as follows. Each company determines its taxable income or loss on an individual basis, according to the ordinary rules, and submits its own tax return (without computing the relative income tax or credit). Then, the common parent aggregates the group's taxable income or loss and computes the consolidated income tax or credit. The total taxable income or loss of each controlled subsidiary is considered regardless of the percentage held by the common parent.

Domestic consolidated groups may take advantage of a rule that allows for a combined computation of E.B.I.T.D.A. and interest expense (see **Interest Deduction** above).

A separate limitation rule applies to losses incurred during a tax period in which a company did not participate in the consolidation regime. These losses are ring-fenced in that company and cannot be brought forward to reduce group income.

Worldwide Consolidation

In addition to the domestic regime, Italian law allows for worldwide consolidation where an Italian-resident company controls one or more nonresident companies. In order for a nonresident company to participate, its financial statements must be audited and an advance approval must be obtained from the Italian tax authorities.

Several differences exist between the domestic consolidation regime and the worldwide regime. First, the worldwide regime is not selective among group members. The option must be exercised by *all* of the nonresident controlled subsidiaries. Furthermore, the first election for worldwide consolidation is effective for five tax periods, and any subsequent renewal is effective for three tax periods. It is believed that the option for worldwide consolidation has been exercised only by a few Italian groups of companies.

C.F.C. Legislation

Profits realized by a C.F.C. are deemed to be the profits of an Italian company if the two following conditions are met:

- The resident company directly or indirectly controls the nonresident entity.
- The foreign entity is resident in a jurisdiction that has a privileged tax regime.[30]

As of 2016, these jurisdictions are defined as countries and territories in which the nominal income tax rate is less than 50% of the Italian rate. Until 2015, the jurisdictions with privileged tax regimes were listed in Ministerial Decree dated November 21, 2001 (the so-called "Blacklist"), as modified by the Ministerial Decree of March 30, 2015.

For purposes of the C.F.C. regime, control is defined according to the Italian Civil Code.[31] A company may be deemed to be controlled in one of three circumstances:

- The Italian resident holds, directly or indirectly, the majority of the voting rights exercised at the general shareholders' meeting of the company.
- The Italian resident holds, directly or indirectly, sufficient votes to exert a decisive influence in the shareholders' meeting of the company.
- The Italian resident exercises a dominant influence over the company due to contractual relationships.

In order to avoid the application of the C.F.C. regime, an Italian-resident company may request a ruling from the Italian tax authorities and provide evidence that (i) the nonresident company carries out an effective industrial or commercial business activity in the market/territory of the country where it is located ("Condition 1"), or (ii) the Italian company does not benefit from a diversion of income into a privileged tax regime ("Condition 2"). As of 2015, an advance ruling is no longer mandatory, provided that the taxpayer can prove during a tax audit that the abovementioned conditions have been met. Where an advance ruling has not been requested or a positive ruling was not obtained, the holding of C.F.C. participations must be disclosed on the relevant tax return. Concerning Condition 1, 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 are derived from (i) the management, holding, or investment in securities, shares, receivables, or other financial assets; (ii) the transfer of or license to use intangible rights of industrial, literary, or artistic property; or (iii) the supply of services, including the financial ones, within the group.[32]

Law Decree n. 78/2009 has also broadened the scope of the C.F.C. rules to include controlled companies not resident in Blacklist jurisdictions if the following conditions

---

30 *Id.*, Article 167, as recently modified by Article 1 (142) of Legislative Decree n. 147/2015.

31 Article 2359 of the Civil Code.

32 Article 167(5-*bis*), I.T.C.

are both met:

- The C.F.C. is subject to actual taxation that is less than 50% of the tax that would have been levied if it were resident in Italy.
- More than 50% of the profits of the C.F.C. are derived from the management, holding, or investment in securities, shares, receivables, or other financial assets, from the disposal or licensing of intellectual property rights, or from the performance of intra-group services.[33]

A safe harbor clause provides that under certain circumstances the C.F.C. rules will not be applicable even if the company meets the conditions outlined above. To qualify for the safe harbor exemption, the resident shareholder must demonstrate that the formation of the C.F.C. in a specific foreign country does not constitute an artificial scheme aimed at achieving undue tax advantages.[34] This can be achieved by applying for an advance tax ruling. In cases where an advance ruling was not requested or a positive ruling was not obtained, an exemption under the safe harbor clause may also be disclosed on the taxpayer's relevant tax return.

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 for Italian-resident corporations, which is 24%.

Italian law provides for the concept of "previously-taxed income." 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.

TREATY PROTECTION

Italy has tax treaties in effect with over 90 jurisdictions, including many developed countries and significant trading partners. In general, the treaties provide for reduced withholding tax rates in line with the O.E.C.D. Model Treaty. Notable exceptions exist for withholding tax on interest. In the new treaty with the U.S., the withholding tax rate is 10%.

Listed below are the countries that have income tax treaties with Italy that are currently in force and effect:

Albania	Algeria	Argentina	Armenia
Australia	Austria	Azerbaijan	Bangladesh
Belarus	Belgium	Bosnia & Herzegovina	Brazil
Bulgaria	Canada	Chile	China
Republic of Congo	Croatia	Cyprus	Czech Republic
Denmark	Ecuador	Egypt	Estonia
Ethiopia	Finland	France	Georgia
Germany	Ghana	Greece	Hong Kong
Hungary	Iceland	India	Indonesia

[33] *Id.*, Article 167(8-*bis*).

[34] *Id.*, Article 167(8-*ter*).

Ireland	Israel	Ivory Coast	Japan
Jordan	Kazakhstan	Kuwait	Latvia
Lebanon	Lithuania	Luxembourg	Macedonia
Malaysia	Malta	Mauritius	Mexico
Moldova	Montenegro	Morocco	Mozambique
Netherlands	New Zealand	Norway	Oman
Pakistan	Philippines	Poland	Portugal
Qatar	Romania	Russia	San Marino
Saudi Arabia	Senegal	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sri Lanka	Sweden	Switzerland
Syria	Taiwan	Tajikistan	Tanzania
Thailand	Trinidad & Tobago	Tunisia	Turkey
Turkmenistan	Uganda	Ukraine	United Arab Emirates
United Kingdom	United States	Uzbekistan	Venezuela
Vietnam	Zambia		

Italy has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

WITHHOLDING TAXES ON OUTBOUND PAYMENTS

Dividend Withholding – Domestic Law

In general, Italian law provides that dividends distributed by Italian companies are subject to a 26% withholding tax.[35] 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) listed in Ministerial Decree September 4, 1996. The recipient can claim a refund of up to eleven twenty-sixths of the withholding tax incurred, if taxes have been paid on the same income in its country of residence.[36] If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.

For dividends distributed to companies or other entities resident and subject to income tax in E.U. Member States or E.E.S. Countries included on the abovementioned list, a reduced 1.2% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions made to domestic companies (see **Dividend Exemption** above). If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are treated as described above (subject to a 95% exemption).

Parent-Subsidiary Directive

Under the Parent-Subsidiary Directive (the "P.S.D.") as implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may

[35] Law Decree n. 66/2014, converted into Law n. 89 of June 23, 2014.

[36] Article 27(3) of Presidential Decree n. 600/1973.

claim a refund of 26% or 1.2% for withholding tax levied on dividends distributed by Italian subsidiaries. After the amendments enacted by Directive 2003/123/C.E.,[37] the required minimum for direct shareholding in the Italian company was reduced to 10%.

In order for a company to qualify as a parent for the benefit of the P.S.D., certain requirements must be met. First, it must have one of the corporate forms listed in the P.S.D. Second, it must reside for tax purposes in an E.U. Member State. For this purpose, a dual resident company is not considered to be a resident of an E.U. Member State if its residence is allocated to a jurisdiction outside the E.U. under an income tax treaty. Third, the company must be subject to one of the income tax regimes listed in the P.S.D. without the possibility of opting for favorable regimes or exemptions. Finally, it must have held the participation for an uninterrupted period of at least one year.

To demonstrate compliance with the first three conditions, a certificate issued by a foreign tax authority must be submitted. The last condition is corroborated by a declaration. Once the foregoing conditions have been met, the exemption is mandatory.

The general anti-abuse rule ("G.A.A.R.") applies. Therefore, an E.U. parent may not benefit from an exemption arising from holdings that are shown to be artificial or that have been established with the sole or primary purpose of taking advantage of the exemption.[38]

As clarified in Circular Letter n. 6/E of 30 March 2016, under G.A.A.R., the intermediate entity is deemed to have been set up merely as a "conduit entity" or as a part of a "conduit arrangement" if at least one of the following circumstances is met:

- The intermediate entity has a light organization (*e.g.*, employees, offices, and equipment are made available by third companies through management service agreements) and does not carry out real economic activity or has little or no discretion in the decision-making process (a "conduit entity").
- The intermediate entity acts merely as a financial conduit in the context of a specific arrangement (*e.g.*, inbound and outbound payments are symmetrical in term of amount, maturity, etc.), allowing payment to flow through without incurring an additional tax burden because it is not subject to further withholding tax in the state where the intermediate is located (a "conduit arrangement").[39]

Interest and Royalties

Italy has implemented the Interest and Royalties Directive providing for a withholding exemption on payments of interest and royalties made to associated companies resident in E.U. Member States.[40] In order to qualify for the exemption, the recipient must be an associated company resident in another Member State that (a) is subject

---

37 Implemented in Italy by Legislative Decree dated February 6, 2007, n. 49. Article 27-*bis* of Presidential Decree n. 600/1973.

38 See the last paragraph of Article 27-*bis* of Presidential Decree n. 600/1973.

39 See Circular Letter n. 6/E, issued by the Italian Revenue Agency on March 30, 2016.

40 Article 26-*quater*, Presidential Decree n. 600/1973.

to one of the taxes listed in P.S.D. Annex B, and (b) has one of the corporate forms listed in P.S.D. Annex A. Alternatively, the recipient can be a permanent establishment of a company resident in a Member State, granted the permanent establishment is also situated in a Member State. Moreover, the nonresident recipient must be the beneficial owner of the payments.[41]

Two companies may be deemed to be associated under one of two tests: (i) one of the companies directly holds at least 25% of the voting rights at the general shareholders' meeting of the other company, or (ii) a third company, resident in a Member State and having one of the corporate forms listed in P.S.D. Annex A, directly holds at least 25% of the voting rights in both companies. The requisite ownership must be held for at least one year.

Article 23(1) of Law Decree n. 98 of July 6, 2011 introduced a new 5% withholding tax applicable to interest paid to a nonresident that is not the beneficial owner of the payments, provided that

- the abovementioned conditions (a) and (b) are met;
- the interest payment is intended to finance the payment of interest and other proceeds on bonds issued by the recipient;
- the bonds are traded on an E.U.- or E.E.S.-regulated market; and
- the bonds are guaranteed by the paying company, the holding company, or another subsidiary.[42]

Pursuant to Article 26, paragraph 5 of Presidential Decree 600/1973, interest payments made to lenders not resident in Italy are subject to a final withholding tax at a rate of 26%. Double taxation treaties in force between Italy and the lender's country of residence may apply, allowing for a lower withholding tax rate (generally 10%), subject to compliance with relevant subjective and procedural requirements.

"Interest payments made to lenders not resident in Italy are subject to a final withholding tax at a rate of 26%."

However, according to paragraph 5-*bis*[43] of the same Article, final withholding tax does not apply to interest payments on medium-long term loans[44] granted to commercial entities by

- credit institutions established in E.U. Member States;
- insurance companies incorporated and authorized under the law of E.U. Member States;
- foreign institutional investors, regardless their tax status, established in Whitelist jurisdictions and subject to regulatory supervision therein; or
- certain non-banking, state-owned entities (such as the U.K. National Savings Bank).

The abovementioned exemption is available only when the laws governing lending

41 For the definition of "beneficial owner" see *id.*, Article 26-*quater* (4).

42 For more details, see *id.*, Article 26-*quater*.

43 Introduced by Article 22(1) of Law Decree n. 91 of June 24, 2014.

44 Medium-long term loans are loans that have a contractual duration of more than 18 months and 1 day and do not provide a prepayment option for the lender.

activities to the public are not infringed. Therefore, to benefit from the exemption, the lender must comply with all of the regulatory requirements for lending to the public. In particular, credit funds must be E.U. Alternative Investment Funds ("E.U. A.I.F."). Direct lending is not allowed by non-E.U. A.I.F's. To perform direct lending activity in Italy, an E.U. A.I.F. must meet the following conditions:

- It must be authorized to lend by the competent authority in its home Member State.
- It must be a closed-end fund and its operating rules, including those relating to its investors, must be similar to those applicable to Italian credit funds.
- The rules on risk diversification and limitation, including limitations on leverage, applicable to it under the regulations of its home Member State must be equivalent to those applicable to Italian credit funds.

An E.U. A.I.F. planning to commence lending activities in Italy must give prior notice to the Bank of Italy, which then has sixty days to issue a response preventing the E.U. A.I.F. from commencing operations. If this period passes without any communication from the Bank of Italy, lending activities may commence.

Nonresident Company with a Permanent Establishment

Companies with a permanent establishment in Italy are taxed on the income of the permanent establishment. Permanent establishment income is determined under the rules applicable to income of resident companies, including the participation exemption regime (see **Participation Exemption for Gains**). Pursuant to the new Article 152(2) I.T.C., replaced by Article 7(3) of Legislative Decree n. 147/2015 (the "International Tax Decree"), Italy applies the O.E.C.D.'s "functionally separate entity approach" when determining permanent establishment income. According to this methodology, income attributed to the permanent establishment will reflect an arm's length amount, *i.e.*, the amount the permanent establishment would have earned if it were a separate and independent enterprise engaged in comparable activities under comparable conditions. This arm's length amount should account for the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment.

Article 152(2) also provides that adequate "free capital" must be attributed to the permanent establishment for tax purposes. Again, the amount is determined based on O.E.C.D. principles (*i.e.*, taking into account the functions performed, assets used, and risks assumed by the permanent establishment).

Nonresident Company with No Permanent Establishment

Nonresident companies without a permanent establishment in Italy are taxed on income generated in Italy under the rules applicable to resident individuals.[45] In particular, they are deemed not to have business income.

Where the foreign corporation sells an interest in an Italian subsidiary, the tax treatment depends on whether the participation is qualified. If the participation is qualified, 49.72% of the capital gains are included in taxable income and are subject

[45] Article 151-152(2) I.T.C.

to I.R.E.S.[46] If the participation is not qualified and the disposition relates to a participation in a listed company, capital gains are deemed to have been generated outside of Italy.[47] If the participation is not qualified and the disposition relates to a participation in a private company, capital gains are not taxed if the shareholder is resident in a country that has an agreement allowing for an adequate exchange of information with Italy.[48]

Finally, if (i) the participation is not qualified, (ii) the disposition relates to a participation in a private company, and (iii) the shareholder is resident in a country without adequate exchange of information, capital gains are subject to a 26% substitute tax.[49]

A participation in a listed company is deemed to be qualified if the total interest sold during a 12-month period is greater than 2% of the company's voting rights or 5% of the capital of the listed company. If the company is not listed, a participation is qualified if the total interest sold during a 12-month period is greater than 20% of the company's voting rights or 25% of the capital of the company.

These rules are subject to modification under an applicable treaty.

BRANCH EXEMPTION REGIME

The International Tax Decree introduced the "branch exemption regime."[50] As of 2016, an Italian-resident company may be exempt from Italian tax on income and losses arising from foreign permanent establishments.

The election of exempt treatment is irrevocable and "all-in" – it is applicable to all qualified existing permanent establishments. Branches falling within the scope of the C.F.C. rules will not qualify unless one of the conditions for C.F.C. exemption is met (see **C.F.C. Legislation**).

A loss recapture provision applies if the branch has incurred a net tax loss over the five-year period prior to the election. In this case, branch income will be included in the taxable basis of the Italian parent company, up to the amount of the pre-existing tax losses, with a corresponding foreign tax credit.

FOREIGN TAX CREDIT

A foreign tax credit is granted to avoid international double taxation.[51] The tax credit is calculated on a per-country basis. Excess credits may be carried back and car-

---

46 *Id.*, Article 68(3). A forthcoming Ministerial Decree will amend this percentage to account for the new corporation income tax rate of 24% applicable as of 2017 (see Article 1(64) of Law n. 208 of December 28, 2015). Once the Decree is issued, the taxable portion of capital gains will be increased from 49.72% to 58.14%.

47 Article 23(1)(f) I.T.C.

48 Article 5(5)(a), Legislative Decree n. 461/1997.

49 *Id.*, Article 5(2).

50 See the new Article 168-ter I.T.C., introduced by Article 14 of Legislative Decree n. 147/2015.

51 *Id.*, Article 165.

ried forward over an eight-year period.[52]

TRANSFER PRICING

The Italian transfer pricing regime is currently contained in Article 110(7) I.T.C.

Pursuant to Article 110(7),[53] business income of an Italian-resident enterprise derived from (i) transactions with a nonresident company[54] that is directly or indirectly controlled by the Italian enterprise; (ii) operations where the foreign company controls the Italian company; or (iii) transactions between resident and nonresident companies that are under the common control of a third company, is assessed on the basis of conditions and prices that would be agreed upon by independent parties operating at arm's length conditions and in comparable circumstances.

Following certain amendments,[55] Article 110(7) no longer refers to the "normal value" of goods and services as defined in Article 9(3) I.T.C. as a criterion for determining intercompany transfer prices. It now refers instead to the "arm's length value," which can be compared to the arm's length value as defined by the O.E.C.D. Guidelines and the O.E.C.D. Model Convention.

Article 110(7) as revised further states that the application of the "arm's length principle" applies in the case of both upward and downward adjustments in taxable income. Downward adjustments in taxable income may result from

- binding agreements concluded with the competent authorities of a Contracting State pursuant to a mutual agreement procedure provided for by a double tax treaty or E.U. Directive 90/436 (the "Arbitration Convention");
- the completion of tax audits carried out in accordance with the Convention on Mutual Administrative Assistance in Tax Matters; or
- rulings requested by the taxpayer in which the tax authorities of a Contracting State with an adequate exchange of information with Italy have made a corresponding and definitive upward tax adjustment according to the arm's length principle – in such a case, the taxpayer's right to request a resolution under the mutual agreement procedure of the applicable tax treaty or the Arbitration Convention remain unchanged.

Legislative Decree 78 of May 31, 2010 introduced Italian regulations for intercompany transfer pricing documentation. Although such documentation is not mandatory, this decree waives the application of administrative penalties (otherwise ranging from 90% to 180% of the tax assessed) if the taxpayer provides the relevant transfer pricing documentation to the tax authorities during a tax audit.

Over the past few years, the Italian tax authorities have paid increasing attention to intra-group transactions during tax audits, and the number of audits of intra-group transactions within multinational groups has risen.

---

52 *Id.*, Article 165(6).

53 As amended by Article 59 of the Law Decree n. 50 of April 24, 2017.

54 In this regard, Article 5(2) of Legislative Decree n. 147/2015 clarifies that the arm's length rule is not applicable to transactions between resident enterprises.

55 See Article 59 of Law Decree n. 50 of April 24, 2017.

PATENT BOX REGIME

In 2015, an optional "Patent Box" regime was introduced in Italy by Article 1 of Law n. 190 of December 23, 2014[56] and enacted by Ministerial Decree dated July 30, 2015.

The exercise of this option is binding for a period of five years and it can be renewed.

The Patent Box regime grants a 50% exemption (reduced to 30% for 2015 and 40% for 2016) from I.R.E.S. and I.R.A.P. on income derived from certain intangible assets, such as patents, copyright protected software, and other intellectual property ("I.P. assets"). According to Article 59 of the Law Decree n. 50 of April 24, 2017, trademarks are no longer considered eligible I.P. assets. The new provisions affect applications to the Patent Box regime submitted after December 31, 2016, while applications submitted before December 31, 2016 are covered by grandfathering provisions and the terms of the previous regime will continue to be valid for the entire five-year duration of the Patent Box election. The provisions making trademarks ineligible were introduced in order to align the Italian Patent Box regime with O.E.C.D. Guidelines.

The Patent Box regime also applies to income derived from the joint use of intangible assets, linked to each other by complementary constraints, with the purpose of realizing a product (or a family of products) or a process (or a group of processes). In the latter case, all the jointly-used intangibles must be assets eligible for the regime. I.P. income – which is eligible for the exemption – is determined using a specific ratio of "qualifying expenses" (*i.e.*, certain research and development expenditures related to I.P. assets) to "overall expenses" (*i.e.*, the sum of the qualifying expenses and the acquisition costs of I.P. assets).[57]

In addition to the benefit for income generated from I.P. assets, the Patent Box regime also provides a special exemption for capital gains arising from the disposal of these assets. In order to benefit from this measure, at least 90% of the proceeds from the sale must be reinvested in maintenance or development of other I.P. assets. Reinvestment must take place by the end of the second fiscal year following the year in which the transfer occurred.

THE AUTOMATIC EXCHANGE OF INFORMATION

Italy supports the Automatic Exchange of Information ("A.E.O.I.") for tax purposes and is actively involved in implementing A.E.O.I. within the E.U. and O.E.C.D., and on a bilateral basis.

On January 10, 2014, the U.S. and Italy signed an intergovernmental agreement ("I.G.A.") to implement the F.A.T.C.A. regime. The I.G.A. was then ratified and enacted in Italy by Law n. 95 of June 18, 2015. Moreover, the Ministerial Decree of August 6, 2015 and the Provisions of the Director of the Italian Revenue Agency

---

[56] Law Decree n. 3 of January 24, 2015 introduced a number of amendments to the regime introduced by Law n. 190/2014. These changes reflect the guidelines set out in the O.E.C.D.'s B.E.P.S. Report on Action Item 5 regarding the modified nexus approach for I.P. regimes (see **Patent Box Regime**).

[57] Article 9 of Ministerial Decree dated July 30, 2015.

dated August 7, 2015 and April 28, 2016 provided the technical rules for the collection and the communication of the requested information.

In accordance with the F.A.T.C.A. rules, the Italian legislation provides, in brief, for A.E.O.I. as follows:

- Italy will engage in bilateral exchange of information with the U.S. in relation to accounts held in Italian financial institutions by U.S. persons.
- Financial institutions must forward specified information to the Italian Tax Authorities, which will, in turn, transmit the data to the I.R.S.
- If certain conditions are met, holding companies may be subject to the F.A.T.C.A. reporting regime.
- The reporting deadline for information related to tax year 2015 was June 15, 2016 (after 2016, the deadline will be April 30 of the following year).

Similar reporting requirements have recently been introduced for countries other than U.S. As of 2016, the Common Reporting Standard (the "C.R.S.") and Directive 2014/107/E.U.[58] ("D.A.C.2"), regarding A.E.O.I. between tax authorities, are applicable in Italy. These rules were implemented in Italy by Law n. 95 of June 18, 2015 and enacted by the Ministerial Decree dated December 28, 2015.

Italian implementation of F.A.T.C.A., the C.R.S., and D.A.C.2 has a common purpose: to prevent tax evasion by foreign individuals who maintain financial relationships with Italian financial institutions. In particular, these regulations require Italian financial institutions to identify their customers in accordance with specific criteria and to communicate certain information (regarding, *inter alia*, interest income, dividends, and similar types of income; account balances; and sales proceeds from financial assets) to the relevant tax authorities.

ITALIAN MEASURES TO COMBAT B.E.P.S.

Fifteen specific actions are being developed in the context of the O.E.C.D./G-20 project to combat base erosion and profit shifting (the "B.E.P.S. Project"). In substance, these actions cover all the principal aspects of international taxation – as they relate to C.F.C. rules, interest deductibility, artificial avoidance of permanent establishment status, transfer pricing rules, curbing harmful tax practices, data collection, mandatory disclosure rules, and dispute resolution.[59]

Italy is already compliant with most of these actions:

- As recommended by Action Item 13, Italy has introduced Country-by-Country Reporting obligations into domestic law (see Article 1(145-147) of Law n. 208 of December 30, 2015).
- In order to incorporate the guidelines under Action 5, Italy has introduced several amendments to the Patent Box regime in Law n. 190/2014 (see **Transfer Pricing** above). Revisions to the regime introduced by Decree Law n.

[58] For exchanges between E.U. Member States, the E.U. has implemented the C.R.S. through D.A.C.2.

[59] For a list of all B.E.P.S. Actions, see **B.E.P.S. and Holding Companies**.

3/2015 ensure that Patent Box benefits are granted only to income that arises from intellectual property for which actual R&D activity was undertaken by the taxpayer. This treatment is in line with the nexus approach recommended in Action Item 5 (see the explanatory document of Law n. 190/2014). The provisions excluding trademarks from Patent Box eligibility were also introduced to align the Italian Patent Box regime with O.E.C.D. Guidelines.

- In order to promote tax transparency and disclosure initiatives under Action Items 5 and 11, a voluntary disclosure procedure has been introduced in Italy. In furtherance of this procedure (and O.E.C.D. recommendations), the Italian government has recently signed agreements with Andorra, Barbados, the Cayman Islands, Chile, Cook Islands, Gibraltar, Guernsey, Hong Kong, the Isle of Man, Jersey, Liechtenstein, Luxembourg, Monaco, San Marino, Switzerland, Taiwan, and Vatican City regarding the exchange of information.

Moreover, many of the new tax rules provided by the International Tax Decree appear to be closely linked to B.E.P.S. Project reports released in 2014 and 2015, such as

- the modification of advance ruling procedures for international companies related to (i) transfer pricing operations, (ii) the existence of a permanent establishment, and (iii) the attribution of profits to a permanent establishment, in order to provide for the spontaneous exchange of information by the Italian tax authorities (see new Article 31-*ter* of Presidential Decree n. 600 of September 29, 1973, introduced by Article 1 (2) of the International Tax Decree);

- the (i) adoption of an "effectively connected income concept" for permanent establishments, repealing the so-called force of attraction rules, which – pursuant to previous rules – had provided for the taxation of certain income produced in Italy but not effectively linked to the permanent establishment, and (ii) introduction of the branch exemption regime (see **Nonresident Company with a Permanent Establishment** above); and

- the reform of the C.F.C. rules to provide for (i) the repeal of the mandatory ruling procedure in order to obtain exemption for foreign subsidiaries, and (ii) the abolition of C.F.C. regimes for "affiliated" companies (*i.e.*, at least 20%-owned by an Italian resident, or 10%-owned if the parent company is a listed company), among other revisions (see **C.F.C. Legislation** above).

"Many of the new tax rules provided by the International Tax Decree appear to be closely linked to B.E.P.S. Project reports released in 2014 and 2015."

Other tax measures provided by the International Tax Decree are intended to comply with rulings of the E.C.J. These include

- the new rules regarding domestic tax consolidation, which extend the option to apply the Italian consolidation regime to "sister" companies (including permanent establishments) that are controlled by the same foreign company resident in an E.U. Member State or E.E.A. Country, allowing adequate exchange of information (see **Domestic Consolidation** above);[60] and

- revisions to the regime for outbound transfers of tax residence, which (i) extend the possibility to defer exit tax on transfers of residence out of Italy as the result of a business merger, and (ii) expressly confirm the application of

[60] *SCA Group Holding and Others*, Joined Cases C-39-41/13, [2014] E.C.R. I____ (delivered June 12, 2014).

the regime to Italian permanent establishments of foreign companies[61] (see Articles 166 and 179 I.T.C., as modified by Article 11 of the International Tax Decree).

Furthermore, Legislative Decree n. 128 of August 5, 2015 (the "Certainty Decree") reviewed Italy's anti-avoidance rules and anti-abuse regime. The Certainty Decree introduced a legal definition of "abuse of law" (see the new Article 10-*bis* of Law n. 212 of July 27, 2000) in order to improve "cooperative compliance," as suggested by the O.E.C.D., and to comply with European Commission recommendations on aggressive tax planning (2012/772/E.U.).

TAX REGIME FOR HOLDING COMPANIES CLASSIFIED AS S.I.C.A.F.'S

According to the new definitions of undertakings for collective investment ("U.C.I.'s") and alternative investment fund managers ("A.I.F.M.'s") provided by Legislative Decree n. 44/2014 (the "A.I.F.M. Decree"), which implements Directive 2011/61/E.U. (the "A.I.F.M. Directive"), some Italian holding companies could be deemed to be S.I.C.A.F.'s and, therefore, be subject to the tax regime applicable to U.C.I.'s. It should be noted that such treatment would be an exception to the general rule, according to which holding companies do not fall within the new definitions of U.C.I. and A.I.F.M.

In particular, both the A.I.F.M. Decree and the A.I.F.M. Directive provide that a holding company is outside the scope of the respective legislation if it is a company that has shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies, or participations in order to contribute to their long-term value, and which is either a company: (i) operating on its own account and whose shares are admitted to trading on a regulated market in the E.U.; or (ii) not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents.[62]

Conversely, it seems that holding companies other than those described above could fall within the scope of the A.I.F.M. Decree and A.I.F.M. Directive and, in particular, within the definition of a S.I.C.A.F. (*i.e.*, a closed-end U.C.I. in the form of a joint stock company with fixed capital and a registered office and general management in Italy, its exclusive purpose being the collective investment of assets obtained by the offer of its own shares and other financial instruments of equity held by the same). If a holding company is deemed to be a S.I.C.A.F., it is subject to the tax regime applicable to U.C.I.'s, which is unlike the tax regime for holding companies described above.

In principle, a U.C.I. is considered liable for tax in Italy as if it were a normal joint stock company – but it is exempt from income tax, and as a consequence, the group

---

[61] *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, Case C-371/10, [2011] E.C.R. I-12273; *European Commission v. Portuguese Republic*, Case C-38/10, [2012] E.C.R. I___ (delivered September 6, 2012).

[62] Article 4 of the A.I.F.M. Decree and A.I.F.M. Directive.

tax consolidation regime mentioned above is not permitted.

While the S.I.C.A.F. itself is exempted from income tax, the profits arising from investments carried out by such an entity are taxed at the investors' level through the application of a withholding tax. The withholding tax rate will depend on tax residence and subjective status of the investor. Hence, certain tax regimes described above, such as the dividend exemption or the participation exemption, are not applicable.[63]

---

[63] Therefore, in the absence of specific transitional rules, the transformation of a holding company that has the legal form of a corporate entity into a S.I.C.A.F. could lead to taxation of any unrealized gains on its assets, since such an operation could be considered, from a tax point of view, to be a transformation of a corporation into a "non-commercial" entity.

GERMANY

Author
Dr. Wolf-Georg von Rechenberg
CMS-Hasche Sigle
Berlin, Germany

INTRODUCTION

In the past few years, several steps have been taken to make Germany a more attractive jurisdiction for holding companies, especially within the E.U. At the same time, efforts have been made to prevent multinational businesses from using international financing structures which treat interest paid to shareholders as business expenses in Germany while leaving the profits of business operations taxable in tax havens.

In determining Germany's advantages as an investment location, judgment should not rest solely on the tax rate: whereas the base corporate tax rate of 15% seems to be very attractive, the effective tax rate can range to about 30% due to the added trade tax burden. Nevertheless, preferred tax treatment for dividends received from other companies and capital gains from the sale of participations in addition to an exemption from dividend withholding tax for dividends paid to companies resident in E.U. Member States has ultimately created a competitive tax environment for investments in Germany. This is particularly interesting given that the German economy has not suffered from the worldwide financial crisis to the same extent as other European economies, making Germany an attractive location for holding companies and active investments. In addition, Germany has one of the largest tax treaty networks, with only a few countries, such as Brazil and Saudi Arabia, being excluded.

GENERAL TAXATION OF GERMAN CORPORATE ENTITIES

A German holding company is subject to both corporate tax and trade tax. The regular corporate tax rate is 15% (plus a 5.5% solidarity surcharge on the corporate tax liability). On top of the corporate tax, trade tax must be paid by most companies. Trade tax is a municipal tax and the rate is determined by each municipality, which leads to an effective trade tax rate between 7% and 17%, with the average being 14%. Therefore, the effective tax burden for a corporate entity is about 30%. It should be mentioned that there is special trade tax treatment for pure real estate companies. Under certain circumstances, these companies are fully exempt from trade tax. This makes Germany a very attractive place for real estate holding companies no matter where in Germany the real estate is located.

The taxable base for corporate tax, solidarity surcharge, and trade tax is the income defined through the tax balance sheet, with certain adjustments for income taxable as defined by the Trade Tax Act.

GENERAL PARTICIPATION AND DIVIDEND EXEMPTION

Background

In Germany, corporate tax is levied on the profit of a corporation as computed in the company's commercial balance sheet and adjusted for tax purposes. There is no difference in the treatment of distributed or retained profits.

Dividends and capital gains received from corporations within or outside of Germany are essentially exempt from German corporate tax, provided that, in the case of dividends, the corporation holds at least 10% of the corporation making the dividend payment. However, 5% of these dividends or capital gains are treated as nondeductible expenses, resulting in an effective tax of less than 2% on these profits. To avoid the use of hybrid financing structures, this beneficial treatment has recently been restricted. The dividends received are now fully taxable in cases where they are treated as a deductible expense for the subsidiary making the distribution.

In general, a German-resident corporation is obliged to remit withholding tax on dividends paid to foreign and domestic shareholders at a rate of 25%, plus a solidarity surcharge. This withholding tax ("*Kapitalertragsteuer*") is credited in full against the individual tax liability of the recipient. As the final tax rate on dividend income and capital rate gains for individuals is basically a flat tax rate (irrespective of the individual tax rate), no further tax is due. In the case of business income, 60% of the income derived from dividends and capital gains is subject to the regular tax rate resulting from the tax assessment. Again, the withholding tax will fully be credited against the respective income tax liability.

Participation Exemption

A 95% participation exemption applies to capital gains on participations in domestic and foreign entities. Neither a certain holding period nor any minimum participation is required. It also applies for trade tax purposes. The 95% participation exemption includes profits from recaptures and hidden profit distributions upon the sale of shares below fair market value.

The participation exemption applies to a participation held directly or indirectly through a partnership. This may be the case when Corporation A disposes of a share in a partnership that owns an interest in Corporation B, or when a partnership disposes of a participation.[1] The participation exemption in partnership structures also applies for trade tax purposes.

However, there are certain exceptions with regard to this tax-free treatment, the most important of which are as follows:

- The exemption does not apply when a tax-deductible write-down of the shares has been carried out in the past and has not been reversed by the time of sale.[2]
- The exemption does not apply to shares held as current assets by a company

1 German Corporate Income Tax Act, §8b, ¶6 ("C.I.T.A.").

2 *Id.*, §8b, ¶2, sent. 4.

engaged in financial business ("*Finanzunternehmen*") that is more than 50% directly or indirectly owned by a financial institution.

- A general exception from the 95% participation exemption exists for banks and financial institutions, and also for life and health insurance companies.

Reductions in profits arising from corporate stock holdings (in particular, extraordinary write-downs) are disregarded in determining taxable income. This exception also applies to shareholder debt in the following circumstances:

- Reductions in profits in connection with a loan (*e.g.*, write-downs to going-concern value, forgiveness of the unrecoverable portion of a debt claim)
- Reductions in profits in connection with securities and guarantees given for a loan
- Reductions in profits resulting from legal acts that are the economic equivalent of a loan

"The denial of a deduction does not apply where it is shown that an unrelated third party would have made the loan under the same circumstances or would not have required its repayment."

This provision applies to loans made or security posted by (i) substantial shareholders (those holding more than 25% of the share capital either directly or indirectly), (ii) persons related to substantial shareholders, and (iii) third parties with a right of recourse against substantial shareholders and their related persons. The statute continues to apply even when the shareholder is no longer a substantial shareholder at the time of the reduction in profits.

The denial of a deduction does not apply where it is shown that an unrelated third party would have made the loan under the same circumstances or would not have required its repayment (arm's length exception). Only security given by the company in question (the debtor) is taken into account for purposes of the arm's length exception.

Dividend Exemption

The dividend exemption applies to dividends received from domestic and foreign participations.[3] For corporate tax purposes, there is no holding period. However, the dividend exemption applies only if the corporation holds a minimum participation of 10%.[4] Below that threshold, the entire dividend payment is subject to tax at a rate of about 30%.

The dividend exemption also applies for trade tax purposes, if a participation of at least 15% has been held at the beginning of the tax year. In the case of foreign dividends received, a participation of at least 15% must be held for an uninterrupted period since the beginning of the tax year and the foreign company must pass an activity test. For participations in E.U. subsidiaries, a participation of 10% qualifies for the dividend exemption and no activity test is required.

Similar to the 95% participation exemption, the dividend exemption is limited to 95% of the dividend received, as 5% of all dividends received are deemed to be nondeductible expenses. In principle, this applies regardless of the amount of effective business expenses related to the dividend. The hybrid mismatch rule applies as explained above under **Background**.

---

[3] *Id.*, §8b, ¶1.

[4] *Id.*, §8b, ¶4.

If the entity receiving the dividend has a participation of less than 10% in the paying entity, the dividends received do not qualify for the exemption and are not deemed to be 5% nondeductible.

Financing Expenses

Despite the capital gains and dividend exemption, financing costs related to the acquisition of shares are, in principle, fully deductible for corporate tax purposes, within the limitations of the earning stripping rules (see **Earnings Stripping Rules** below). This is an exception to the general rule of German tax law which provides that business expenses incurred in relation to tax-exempt income (*i.e.*, dividends or capital gains) are not tax deductible.[5]

A different rule is applicable for trade tax purposes. When computing trade tax income, 25% of the interest on debt exceeding €100,000 is added back to the tax base.

TRADE TAX ADD-BACKS AND DEDUCTIONS

The income computed for corporate tax purposes is adjusted for trade tax purposes by various add-backs and deductions.

The add-backs include 25% 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;
- the distributive share of profits from an investment in a domestic or foreign partnership;
- dividends from a domestic corporation in which the Taxpayer holds an interest of at least 15% since the beginning of the tax year; and
- dividends from a foreign corporation in which the taxpayer holds an interest of at least 15% (10% in a case where the E.U. Parent-Subsidiary Directive is applicable) since the beginning of the tax year, provided this corporation (almost exclusively) generates active income.[6]

5 Income Tax Act, §3c, ¶1 ("I.T.A.").

6 The active business requirement is not applicable to companies resident in an E.U. Member State.

EARNINGS STRIPPING RULES

General Concept

With the 2008 Business Tax Reform Act, earnings stripping rules were introduced into the German income tax law, replacing the former thin capitalization rules.[7] The earnings stripping rules apply in general to all types of debt financing for sole entrepreneurships, partnerships, and corporations. The scope of the rules is far broader than the former thin capitalization rules, as any third-party debt financing (whether or not there is back-to-back financing) will be included. Interest expense is completely deductible from the tax base only to the extent the taxpayer earns positive interest income in the corresponding financial year. Interest expense in excess of interest revenue (net interest expense) is deductible only up to 30% of tax E.B.I.T.D.A. (interest deduction ceiling).

Tax E.B.I.T.D.A. is defined as the taxable profit before the application of the interest deduction ceiling, increased by interest expenses and by fiscal depreciation and amortization, and reduced by interest earnings.

For purposes of the earnings stripping rules, the controlling company and the controlled companies of a tax group are treated as a single entity. Thus, the earnings stripping rules are not applicable at the level of the controlled company. The interest expense and interest revenue of the controlled company and the controlling company are aggregated.

Nondeductible interest expense in a considered period may be carried forward (known as "interest carryforward"). As is the case with the year in which interest carryforward arises, when carried to a subsequent year, the interest carryforward is not taken into account in determining the tax E.B.I.T.D.A. They simply may be claimed as deductions to the extent the net interest expense in the subsequent year is less than the 30% of E.B.I.T.D.A. for that year. In a similar way, any tax E.B.I.T.D.A. amount that is not consumed by interest expense for the purpose of the earnings stripping rules in a particular year may also be carried forward (known as "E.B.I.T.D.A. carryforward") to increase the ceiling in the carryforward year.

Exemptions

A *de minimis* rule applies to the earning stripping limitations on the deductibility of net interest expense. The earnings stripping rules apply only when interest expense exceeds positive interest income by at least €3 million (the "tax threshold"). Thus, small- and medium-sized business enterprises are generally exempt from the scope of the earnings stripping rules, provided the tax threshold for a year is not reached or exceeded.

The earnings stripping rules also do not apply to businesses that are not 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. 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

[7] I.T.A., §4h; C.I.T.A., §8a.

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.

Furthermore, there is an escape clause for businesses that are part of a controlled group. Provided that the entity in question's equity ratio – the percentage of balance sheet assets funded by equity – is equal to or greater than the equity ratio of the controlled group, the earnings stripping rules do not apply. There is a 2% safety cushion for the equity ratio of the business in question. Consequently, the escape clause may be met when the equity ratio of the entity is 48% and the equity ratio of the controlled group is 50%. As indicated above, the calculation of the equity percentage of the business must be based on the values of the assets and liabilities as reflected in the consolidated financial statements.

The exemption for non-controlled corporations and the escape clause apply only if the corporation establishes that remuneration on shareholder debt accounts does not exceed 10% of the net interest expense of the relevant entity.[8] Shareholder debt is defined as debt that is granted by a substantial shareholder,[9] by an affiliated person, or by a third party having recourse against a substantial shareholder or affiliated person. Debt financing between companies of the same consolidated group is not adversely affected by these rules. The Federal Supreme Tax Court has raised concerns that these rules violate the constitutional right of equal treatment in certain cases involving third party financing and has referred the decision to the Federal Constitutional Court. As of May 2017, no court judgment has been rendered in this respect.

RESTRICTING TAX DEDUCTIONS ON LICENSE PAYMENTS

In December 2016, the German Ministry of Finance introduced a bill proposing the addition of a new section to the German Income Tax Act that would restrict the tax deductions applicable to royalties and similar payments.[10] The legislation was approved by the upper house of the German Parliament in June 2017 and the new section will apply to royalty expenses incurred after December 31, 2017.

The new section restricts the deduction of royalties and similar payments made to related parties if, in the other country, the payments are (i) subject to a preferential tax regime, such as an I.P. Box regime, and the rules in the other country are not compliant with the O.E.C.D. nexus approach presented in its B.E.P.S. Report on Action Item 5, and (ii) subject to an effective tax rate of less than 25%. A safe harbor exists for royalty payments to a company that carries on substantial research and development activities.

If the law applies, the percentage of the payment that will be nondeductible is calculated by making reference to the percentage shortfall between the effective rate and 25%. Stated mathematically, the formula is (25% - effective tax rate) ÷ 25%. For

8 C.I.T.A., §8a, ¶2.

9 Shareholder of more than 25%.

10 I.T.A., §4j.

instance, if the effective foreign preferential tax rate is 10%, German law would regard 60% of all royalty payments as nondeductible. Because 10% amounts to 40% of 25%, the shortfall between the effective rate and 25% is 15% – which is 60% of 25%.

The new legislation also captures indirect license payments and will apply irrespective of any tax treaties (*i.e.*, treaty override).

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 minimum-taxation rules.[11] According to these rules, losses may only be deducted from recent profits up to €1 million. Of losses in excess of this amount, only 60% may be deducted. The nondeductible 40% of the exceeding amount will again be carried forward.

A sister provision of German tax law that restricted the use of loss carryforwards was recently held to be invalid. It applied when more than 25% of the shares in a loss company were transferred within a five-year period. Under the provision, when more than 25% but not more than 50% of the shares are transferred, the loss carryforward is reduced by the percentage of the issued and outstanding shares transferred. If more than 50% of the shares are transferred within five years, all of the loss carryforward becomes nondeductible.[12]

This was a major impediment to sales of troubled companies because oftentimes considerable loss carryforwards could not be used to offset the profits resulting from financial restructuring measures put in place by new investors. The statute allowed only a few exceptions, such as a transfer of shares within a group or where sufficient hidden reserves were available to compensate for the losses.

The restriction on use of loss carryforwards was challenged in court, and in a recent judgment rendered by the Federal Constitutional Court in May 2017, §8c of the C.I.T.A. was held void for tax periods up to December 31, 2016. The restriction breached constitutional law and the court ordered the legislature to draft a new bill to deal with the losses incurred up to December 31, 2015. Currently, it is unclear how the legislature will react or deal with the losses resulting from this invalid legislation.

The Federal Constitutional Court did not rule on the wording of §8c of the C.I.T.A. as of January 1, 2016. As of the writing of this article, a new statutory provision has been introduced that allows an investor to use the losses incurred prior to the acquisition of 25% or 50% of the shares in a company if the investor continues the company's operating business.[13] There are strict requirements to be met in order to be able to use the losses incurred in the time prior to the acquisition, and it remains unclear whether §§8c and 8d of the C.I.T.A. can be considered valid in light of the recent judgment of the Federal Constitutional Court.

C.F.C. TAXATION

German tax law provides specific regulations for a shareholder of a controlled

[11] *Id.*, §10b.

[12] C.I.T.A., §8c.

[13] *Id.*, §8d.

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 passive income, and
- the foreign corporation is subject to low taxation (*i.e.*, its effective tax burden as determined according to German tax principles is below 25%).

"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."

Passive income is defined as income that is not explicitly classified as active under the C.F.C. regulations. Classified active income includes income from manufacturing, trading, the provision of services, and some forms of licensing and renting, with the exception of certain structures designed to reallocate taxable income from Germany to a tax haven. Dividends, constructive dividends, and, in principle, capital gains are active income, as well. The classification of capital gains as active income depends on the activity of the target company sold by the C.F.C.

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 it is realized by the C.F.C. The German shareholder does not benefit from applicable treaty provisions, and the general dividend exemption does not apply.[14]

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. that maintains its registered office or place of management in a member country of the E.U. or E.E.A., provided the company carries on genuine economic activities in that country.[15] Genuine economic activities require a full-fledged business with an appropriate office, employees, and technical equipment. Generally, "genuine economic activities" are determined by the criteria stated by the European Court of Justice in the *Cadbury Schweppes* decision. Only such income that is attributable to the genuine economic activity and that is derived by that particular activity is exempt from the C.F.C. rules, and only for amounts that do not exceed arm's length consideration. This exemption was introduced in response to the *Cadbury Schweppes* decision.

---

14 Foreign Relations Taxation Act, §10, ¶2, sent. 3 ("F.R.T.A.").

15 *Id.*, §8, ¶2.

DIVIDEND WITHHOLDING TAX; TREATY NETWORK; ANTI-ABUSE PROVISIONS

Withholding Tax

A nonresident's dividend income is subject to withholding tax collected at the source. The statutory rate of German withholding tax is 25% (plus the solidarity surcharge of 5.5%). Foreign corporations may claim a refund of two-fifths of the withholding tax (the effective withholding tax rate is 15% plus the solidarity surcharge). In many cases, lower rates will be levied under a double tax treaty. No dividend withholding tax will be levied on dividends paid to a parent company resident in the E.U. if the parent has been holding a participation of at least 10% in the subsidiary for the last 12 months.[16]

Treaty Network

Germany has an extensive income tax treaty network with almost 100 income tax treaties in force and effect as of April 15, 2017.

Albania	Algeria	Argentina	Armenia
Australia	Austria	Azerbaijan	Bangladesh
Belarus	Belgium	Bolivia	Bosnia & Herzegovina
Bulgaria	Canada	China	Costa Rica
Croatia	Cyprus	Czech Republic	Denmark
Ecuador	Egypt	Estonia	Finland
France	Georgia	Ghana	Greece
Hungary	Iceland	India	Indonesia
Iran	Ireland	Israel	Italy
Ivory Coast	Jamaica	Japan	Jersey
Kazakhstan	Kenya	Kosovo	Kuwait
Kyrgyzstan	Latvia	Liberia	Liechtenstein
Lithuania	Luxembourg	Macedonia	Malaysia
Malta	Mauritius	Mexico	Moldova
Mongolia	Montenegro	Morocco	Namibia
Netherlands	New Zealand	Norway	Pakistan
Philippines	Poland	Portugal	Romania
Russia	Serbia	Singapore	Slovakia
Slovenia	South Africa	South Korea	Spain
Sri Lanka	Sweden	Switzerland	Syria
Taiwan	Tajikistan	Thailand	Trinidad & Tobago
Tunisia	Turkey	Turkmenistan	Ukraine
United Arab Emirates	United Kingdom	United States	Uruguay
Uzbekistan	Venezuela	Vietnam	Zambia
Zimbabwe			

[16] I.T.A., §43b, ¶2.

Germany has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Anti-Abuse Provisions

Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies, and has modified these rules to avoid further requests for changes from European Commission.[17] Under these restrictions, 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 derived the income directly and at least one of the following conditions applies:

- A foreign corporation may not claim to be exempt from the withholding tax on dividends insofar as its shareholders would not be entitled to this benefit if they received the dividends directly.
- The gross income of the respective company in the respective fiscal year does not come from its own business activities.
- There are no economic or other substantial reasons for involving the company.
- The company has no business of its own and does not conduct general business activities.

Nevertheless, the aforementioned anti-treaty-shopping rules may still be considered to be in violation of European law, and the European Commission may request that the Federal Republic of Germany amend these rules. If Germany fails to react to a formal request, the case may go before the E.C.J.

For shareholdings of less than 10%, withholding tax is applicable for both resident and nonresident shareholders. A different holding percentage may be applicable under the various treaties that are in effect.

TRANSFER PRICING

German Administrative Principles

German tax authorities are empowered to adjust reported income from transactions between related parties that are not carried out on an arm's length basis if the transfer price otherwise agreed upon by the parties would lead to lower taxable income in Germany.

The standard transfer pricing methods that have been confirmed by the legislature are the comparable uncontrolled price method, the resale price method, and the cost-plus-method. In practice, these standard methods may be extended to include other elements, such as global cost allocations. Under certain circumstances, profit-based global methods, such as the profit split method and the transactional net margin method, are accepted by the German tax authorities, whereas the comparable-profit method is not accepted. A hypothetical arm's length test will be applied if it is not possible to determine arm's length transfer prices using a recognized transfer pricing method.

---

[17] *Id.*, §50d, ¶3.

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.

The arm's length principle is also applicable for any transaction with a permanent establishment.

Transfer of Functions

Provisions on the transfer of functions are included in the transfer pricing legislation. A function is transferred if it is relocated abroad with the associated opportunities and risks, including the assets and other benefits, also transferred or otherwise provided.

In principle, a payment in consideration of the transfer shall be calculated for the transfer as a whole. The calculation of this payment is to be based on the impact of the function shifted on the profits of the transferring and receiving companies. The administration issued an extensive legal decree ("*Funktionsverlagerungsverordnung*") in July 2008 and administrative guidelines with practical examples in October 2010.

Documentation Requirements

Germany has introduced extensive rules regarding transfer pricing documentation and penalties. According to the rules, a German taxpayer must document the type of cross-border business transaction carried out with a related party or a permanent establishment abroad and the reasons for setting the transfer price. For extraordinary business transactions, documentation must be prepared on a contemporary basis. On the other hand, for ordinary business transactions, documentation must be presented within 60 days (for extraordinary transactions, within 30 days) of a request during a tax audit. The Federal Ministry of Finance has issued a Federal ordinance on transfer pricing documentation obligations, which has been supported by a decree from the tax authorities.

If a taxpayer fails to comply with the documentation requirements, there is a rebuttable presumption that the income of the German taxpayer is understated. The tax authorities are granted broad discretion to estimate the income of the taxpayer from the transaction. In addition, penalties may be due. The penalties range from 5% to 10% of the additional estimated income, with a minimum penalty of €5,000. If documentation is not presented on a timely basis, penalties of €100 may be imposed for each day of the delay up to €1 million.

GERMAN INVESTMENT LAW TAXATION

The German government is currently in the process of passing a new bill concerning the taxation of German investment funds. Until now, investment funds have widely been exempt from taxation and only individual investors were subject to tax, even if gains were not distributed. The new legislation will change this in respect of funds that are not special funds. The key point of the new legislation is that gains will be taxed at the level of the fund, not at the level of the investors. The aim is to tax national and foreign public investment funds equally. In order to avoid double taxation, certain distributions will be partially exempt from tax. The new law is expected to come into force in 2018, and the details of how it will be enacted remain to be seen.

"The German government is currently in the process of passing a new bill concerning the taxation of German investment funds."

CYPRUS

Author
Nairy Der Arakelian-Merheje
Der Arakelian-Merheje LLC
Nicosia, Cyprus

GENERAL

Now that the effects of the financial crisis have been addressed, Cyprus remains an active and well-structured international business center catering to the requirements of international business entities and professionals. The key factors contributing to the status of Cyprus as an international base for holding companies remain

- its strategic geographic location;
- a favorable tax package with one of the lowest corporate tax rates in Europe;
- a well-developed double tax treaty network;
- a legal system and legislation based on English law; and
- the existence of an efficient, high-level professional services sector.

The Constitution of Cyprus and international treaties ratified by Cyprus safeguard the basic rights of legal entities and individuals.

The main tax provisions relating to Cypriot holding companies have recently been revised to adhere to E.U. directives based on the O.E.C.D.'s recommendations for combatting base erosion and profit shifting ("B.E.P.S. Project"). Tax structures are now carefully scrutinized with regard to the commercial reasoning behind various arrangements.

On December 10, 2015, the House of Representatives voted to approve additional changes to the tax law related to income and capital gains tax, and in the recent months, the government has negotiated with the private sector regarding implementation. These changes, which are summarized in the relevant sections below, are intended to improve the tax system of Cyprus, eliminate provisions that complicate day-to-day application of the law, and make Cyprus more attractive to both the local and international business community.

It should be noted that Cyprus has two revenue raising measures that should be considered when planning to use Cyprus as a base for a holding company. One is the income tax, and the other is the defense levy. Each is discussed in turn.

INCOME TAX

Tax Rate

The flat-rate tax on annual net profit is 12.5%.

Basic Concept

Both Cyprus-resident companies and individuals are taxed on their worldwide income, which includes the following:

- Business income
- Rental income
- Dividends, interest, and royalties
- Goodwill
- Employment income, pensions, and directors' fees

Nonresident companies are taxed on the following categories of income:

- Profits of a permanent establishment in Cyprus
- Rental income on immovable property in Cyprus
- Goodwill for a Cyprus business
- Royalties

Nonresident individuals are taxed only on the following:

- Employment income for services in Cyprus
- Pensions received in Cyprus
- Directors' fees
- Rental income on immovable property in Cyprus
- Royalties
- Fees paid to professionals

New tax-resident, non-domiciled foreigners are exempt from income tax for 17 years.

Residence

The concept of residency status for corporations was adopted in 2003, and tax liability in Cyprus is dependent upon the status of a company as a resident. This is determined by examining the exercise of management and control in Cyprus.

Although "management and control" is not defined in Cypriot tax legislation, it is generally accepted to be in line with international tax principles, namely, that the following conditions should be considered when determining if a company qualifies as a resident of Cyprus for tax purposes:

- All strategic (and preferably also day-to-day) management decisions are made in Cyprus by directors exercising their duties from Cyprus. This is usually achieved by holding meetings of the board of directors in Cyprus and signing written resolutions, contracts, agreements, and other relevant company documents relating to the management, control, and administrative functions of the company in Cyprus. All transactions are scrutinized very carefully, including the qualifications of the directors.

- The majority of the directors of the company are tax-resident in Cyprus and exercise their duties from Cyprus.
- A physical (administrative) office is maintained in Cyprus, from which actual management and control of the business is exercised.
- Hard copies of commercial documentation (*e.g.*, agreements, invoices, etc.) are stored in the company's office facilities in Cyprus.
- Accounting records of the company are prepared and kept in Cyprus.
- Bank accounts of the company are operated from Cyprus, even if the accounts are maintained with banks established outside Cyprus.

Permanent Establishments

In Cypriot income tax law, the definition of a permanent establishment follows the definition found in Article 5 of the O.E.C.D. model convention.

Profits from the activities of a permanent establishment outside of Cyprus are exempt.

New Amendments Since July 2015

As a general rule, residents of Cyprus are taxed on worldwide income. However, several important exceptions apply to this rule. They may be summarized as follows:

Notional Interest Deduction on Equity

Existing Provisions

Currently, interest paid is deducted while calculating the taxable income only when such interest is actually incurred on a loan or other credit facility obtained. The deductibility of the interest expense depends on whether the funds for which the interest is paid have been used to finance taxable operations of the company and to acquire assets considered to be used in the business.

Interest paid to finance intercompany loans is deductible, provided certain acceptable margins are maintained at the level of the Cypriot-resident company.

In practice, the use of back-to-back loans can create beneficial ownership issues with regards to the provisions of certain double tax treaties. However, back-to-back loans are being phased out and banks no longer remit such funds except between related companies.

It should be noted that interest paid on loans to finance the acquisition of investments is only allowed in the case of wholly-owned subsidiaries acquired after January 1, 2012.

New Provisions

Recently, Cyprus has introduced provisions to allow the notional deduction of interest in cases where investment is by way of equity instead of interest-bearing loans.

Similar provisions have existed for years in other competing jurisdictions.

The main provisions of the law are as follows:

- A deemed interest deduction will be allowed on "new equity" funds introduced into a Cyprus-resident company and funds that are used for the business of the company.
- The deemed interest will be calculated on the basis of a "reference interest rate." This rate is equal to the yield on the ten-year government bonds of the country where the new funds are invested, plus 3%, with the minimum rate being the yield on the ten-year government bonds of Cyprus, plus 3%.
- New equity means any equity funds introduced into the business after January 1, 2015, not including capitalization of reserves resulting from the evaluation of movable and immovable property.
- Equity includes both share capital and share premium (ordinary or preferred) to the extent that it has actually been paid up. The consideration for the issue of the shares can also be assets (other than cash), in which case the consideration cannot exceed the market value of the assets contributed. Other forms of equity contribution are not acceptable.
- The notional interest to be deducted cannot exceed 80% of the taxable income of the company for the year before the deduction of this notional interest. Therefore, in years with a tax loss, such a benefit will not be applied.
- The deductibility of the deemed interest will be subject to the same rules as actual interest paid, *i.e.*, it will be tax deductible only if it relates to assets used in the business.
- Claiming of the notional interest is at the discretion of the taxpayer on a yearly basis.

Anti-Avoidance Provisions

Several anti-avoidance provisions are included in the legislation to protect against abuse of the new benefits, such as "dressing up" old capital into new capital, claiming notional interest twice on the same funds through the use of multiple companies, or introducing arrangements that lack valid economic or commercial purposes.

Practical Uses

Taking advantage of the new incentive for deemed interest deductions would result in various benefits and eliminate potential issues. These include the following scenarios:

- Higher share capital, rather than large loans, would be more beneficial from a business operational perspective.
- Under the participation exemption rules, it may benefit the parent company to receive dividends rather than interest, which would be taxable.

  For example, rather than lending its own funds to a subsidiary, a parent company ("Company A") may make an equity contribution to its subsidiary ("Company B"). In the case of an equity contribution, Company A will not have taxable interest income, whereas Company B will get a deemed interest deduction. If Company B distributes the profits (without any actual interest cost) to Company A, then dividends received by Company A could be exempt from taxation.

- In cases where funds are used on back-to-back loans, beneficial ownership issues for interest received under an income tax treaty are subject to strict scrutiny. As a result, back-to-back loans are being phased out.

  To illustrate, assume Company A, a resident of Country A, borrows funds from Company B, a resident of Country B. Company A lends the same funds to Company C, a resident of Country C. In this case, the tax authorities of Country C may refuse tax treaty benefits when Company C makes payments to Company A because Company A is obligated to pay to Company B all or most of the interest received. In these circumstances, Company A is not the ultimate beneficial owner of the interest because of its own obligation to pay the amount received to Company B.

  Compare the foregoing result with a fact pattern in which Company A issues capital stock to Company B in return for a capital contribution. Company A then lends funds to Company C. Since Company A has no legal or contractual obligation to use the interest received from Company C to pay interest to Company B, no beneficial ownership issues should arise in Country C regarding payments to Company A.

Expansion of the Definition of the Republic of Cyprus

The law has been amended so that the definition of the term "Republic of Cyprus" now includes, specifically and clearly, the territorial sea, the contiguous zone, the exclusive economic zone, and the continental shelf of Cyprus.

The law has also been amended so that the definition of a permanent establishment now includes all activities for the exploration and exploitation of the seabed in the exclusive economic zone and services related to such exploration or exploitation activities.

Gross income earned from sources within Cyprus (including those mentioned above) by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus that provides services listed in **Basic Concept** above would be subject to tax at the rate of 5%.

This provision applies as of January 1, 2016.

Tax Losses Group Relief

Under the current provisions of the law, group loss relief can only be given for losses incurred by Cyprus-resident companies. This means that losses incurred by a member of a group of companies can only be surrendered to another member of the same group, provided that both companies are tax residents of Cyprus.

In order to align the Cypriot tax law with the decision by the E.C.J. in the *Marks & Spencer* case, the law has been amended so that a subsidiary company that is tax resident in another E.U. Member State can surrender its taxable losses to another group member that is tax resident in Cyprus, provided the subsidiary has exhausted all the means of surrendering or carrying forward the losses in its Member State of residence or to any intermediate holding company.

When surrendering tax losses, as above, taxable losses must be calculated on the basis of Cypriot tax law.

The law has also been amended to allow, for the purposes of determining whether two companies are members of the same group, the interposition of holding companies established in (i) another E.U. Member State, (ii) a state with which Cyprus has concluded a double tax treaty, or (iii) a state that has signed the O.E.C.D. multilateral convention for exchange of information.

"In practice, correlative adjustments to remove income from one party were not made when the income of the other party was increased. However, the law has now been amended to correct this anomaly."

These provisions apply as of the tax year 2015.

Reorganization of Companies and Anti-Avoidance Provisions

The E.U. directive on mergers, acquisitions, and spinoffs has been implemented in Cyprus. Consequently, mergers, divisions, transfers of assets, and exchanges of shares can be 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 Cypriot tax residents and certain conditions are met.

The scope of the exemption is broad. Gains resulting from the exchange of shares in a merger or reorganization will not be subject to tax. When immovable property is included in the reorganization, capital gains on the transfer will not be subject to capital gains tax. No land transfer fees will be payable on the transfer of immovable property, except if the property is located in Cyprus.

Several anti-avoidance provisions have also been introduced allowing the Tax Commissioner the right to refuse to accept tax-free reorganizations if the Commissioner is not satisfied that real commercial or financial reasons exist for the reorganization. In other words, the main purpose or one of the main purposes of the reorganization is the reduction, avoidance, or deferment of payment of taxes and that fact taints the tax-free nature of the transaction.

The Commissioner has the right to impose conditions on the number of shares which can be issued as part of the reorganization and the period for which such shares should be held (not more than three years).

However, such restrictions cannot apply in the case of publicly-listed companies and transfers of shares as a result of succession.

These provisions apply as of January 1, 2016.

Related-Party Transactions

Under current legislation, the Tax Commissioner has the right to adjust the value of transactions between related parties if such transactions are not carried-out on an arm's length basis.

In practice, correlative adjustments to remove income from one party were not made when the income of the other party was increased. However, the law has now been amended to correct this anomaly. As of January 1, 2015, in the case of an adjustment in the income of one party, a corresponding deduction should be given to the other party to the transaction.

Specific Income Tax Benefits

Certain types of income that may be subject to favorable tax treatments are discussed in the following sections.

Shipping and Aircraft Businesses

Under the reciprocal exemption provisions, in the case of a shipping and aircraft business, profits or benefits arising from the business of operating ships or aircraft are exempt from tax in Cyprus if they are carried on by a person who is not a resident of Cyprus, provided that the Cypriot Minister of Finance is satisfied that there is an equivalent exemption from income tax granted by the country in which such person is resident to persons resident in Cyprus who carry similar business in that other country.

The income of ship-owning companies is tax-exempt, as well as V.A.T.-exempt.

Ship management income is subject to tax under the new tonnage tax legislation, which reduces taxation to very low effective rates. However, specific conditions must be met for these rates to be implemented, otherwise the 12.5% corporate rate applies.

Intellectual Property

Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the effective rate of 5% of the amounts paid. A similar rate of tax is imposed on film rental income derived by a nonresident. However, the E.U. Royalties Directive applies in the case of film rentals.

Royalties granted for the use of I.P. rights outside Cyprus are not subject to withholding tax.

Additionally, a new I.P. Box regime was approved by Law 110 (i) of 2016, published on October 27, 2016, and by Regulations 336/2016, dated November 18, 2016. Circular 2017/4 was issued on March 22, 2017 to address the issue of embedded income.

The I.P. Box allows for an exemption from taxation of 80% of the gross income from use of intangible assets. The key provisions of the regime are discussed below.

Qualifying Intangible Assets

A "qualifying intangible asset" is an asset that was acquired, developed, or exploited by a person in furtherance of its business (excluding intellectual property associated with marketing). The I.P. must be the result of research and development activities. A qualifying intangible asset includes intangible assets for which only economic ownership exists, such as

- patents,
- computer software, and
- certain specified assets.

Qualifying Profits

"Qualifying income" means the proportion of the overall income corresponding to the fraction of the qualifying expenditure plus the uplift expenditure, over the total expenditure incurred for the qualifying intangible asset.

Income includes

- royalties for the use of the asset,
- amounts received from insurance or as compensation,
- gains from the sale of the intangible asset, and
- embedded income of the qualifying asset.

Qualifying Expenditures

A "qualifying expenditure" is the sum of total research and development costs incurred in any tax year, wholly and exclusively for the development, improvement, or creation of qualifying intangible assets, the costs of which are directly related to the qualifying intangible assets.

Transitional Arrangements

Transitional arrangements for persons qualifying under the existing I.P. Box regime are in place with respect to intangibles that were

- acquired before January 2, 2016;
- acquired directly or indirectly from a related person during the period from January 2, 2016 to June 30, 2016, and were at the time of their acquisition benefiting under the I.P. Box regime or similar scheme for intangible assets in another state; or
- acquired from an unrelated person or developed during the period from January 2, 2016 to June 30, 2016 – but such benefits lapse on June 30, 2021.

Specific Allowances and Deductions

Cyprus income tax law now imposes stricter limitations on the ability of a corporation to deduct expenses when calculating net annual taxable income.

Interest income derived from trading activities is subject to the flat 12.5% tax rate, and this is the only tax payable for interest income from ordinary trading activities. Interest income derived from investments attracts the Special Defense Levy, which is discussed below in **The Special Contribution for the Defense of the Republic**.

For corporations, gains from trading in stocks, shares, and securities are generally exempt from income tax. The definition of securities has recently been substantially expanded to grant a broader exemption for Cypriot holding companies that deal in securities.

Pursuant to I.T.L. §8(22), the following instruments are considered securities for the purposes of the exempt capital gains rules:

- Short positions in titles
- Rights of claim on bonds and debentures
- Options on titles

- Founders shares
- Units in open-end and closed-end collective schemes
- Index shares or index bonds
- Futures/forwards on titles
- Preference shares
- Swaps on titles
- Repurchase agreements or repos on titles
- Depositary receipts on titles
- Participations in companies
- Shares in L.L.C.'s registered in the U.S

Dividends paid into a Cypriot holding company are exempt from income tax, and no withholding tax is payable when dividends are paid by a Cypriot holding company to its nonresident shareholders. The combination of an exemption for share gains and an absence of tax on dividend income received or paid by a Cypriot holding company likely accounts for the notable increase in the number of nonresident-owned holding companies in Cyprus since its accession to the E.U. However, this situation is now changing as some countries have begun to treat Cyprus companies as look-through entities if the substance and activities tests are not satisfied.

"Dividends paid into a Cypriot holding company are exempt from income tax, and no withholding tax is payable when dividends are paid by a Cypriot holding company to its nonresident shareholders."

Additionally, a unilateral tax credit is allowed in Cyprus for taxes withheld or paid in other countries where there is no bilateral agreement or double tax treaty in force.

Loan Interest

The 9% notional interest on loans or other financial facilities has been eliminated, but if Cyprus-resident individuals are the recipients, such loans are considered benefits and are taxed as personal income. For corporate shareholders, the arm's length principle will now be applicable, and much lower interest rates are accepted. Back-to-back loans do not generate notional interest and are now being phased out.

Whenever a loan or other financial instrument is provided to individual shareholders or directors of a company (or to their first- or second-degree relatives), the recipient is deemed to receive a benefit of 9% *per annum*, calculated on the outstanding balance of the loan on a monthly basis. This benefit is assessed in the hands of both resident and nonresident directors and shareholders. In the case of nonresident directors and shareholders, the benefit should be deemed to arise only in relation to actual days spent in Cyprus (on a *pro rata* basis).

Also, no restriction is imposed on interest with respect to the acquisition of shares of a directly or indirectly wholly-owned subsidiary company, provided that the subsidiary does not hold assets that are not used in the performance of its business.

Losses may be offset within a group of companies, even if derived in the year in which an entity is incorporated.

In order to encourage investment, factories and machinery acquired during the years 2012, 2013, and 2014 are permitted a 20% depreciation allowance rather than the standard allowance of 10%.

Payroll costs and contributions are not tax deductible if contributions to the Social Insurance Fund, Redundancy Fund, Human Resources Development Fund, Social Cohesion Fund, Pension Fund, and Provident Fund are not paid in the year in which they are due.

Anti-Avoidance Provisions for Hybrid Instruments and Artificial Transactions for Dividends

Under current law, dividends are exempt from income tax but are subject to defense tax for tax-resident Cypriot individuals and, in a number of cases, for companies.

In some cases, a payment received by a Cypriot company from a company located outside of Cyprus may be considered a dividend in Cyprus, while also being treated as a tax-deductible expense in the country of the company making the payment. These are known as "hybrid instruments."

An example of a hybrid instrument may arise where dividends are paid on preferred shares. In Cyprus, these payments are considered dividend income, whereas in the payer's country of residence (*e.g.*, Luxembourg), these payments may be considered interest paid, and therefore, they may be allowed as a tax-deductible expense.

The E.U. Parent-Subsidiary Directive ("P.S.D.") was amended in 2016 to exclude these payments from benefits, and Member States must introduce legislation to avoid the double nontaxation of these dividends. Cypriot tax law has been amended so that dividends that fall under the above provisions will no longer be exempt from income tax when received by a Cyprus-resident company. Instead, these dividends will be taxed as normal business income subject to income tax but exempt from defense tax.

In addition, the P.S.D. has been amended so that it does not apply in cases where there is an arrangement, or series of arrangements, between the dividend-paying company and the dividend-receiving company that have been put into place where the main purpose or one of the main purposes relates to a tax advantage that defeats the object or purpose of the P.S.D. This type of arrangement is not regarded as genuine unless put in place for valid commercial reasons which reflect economic reality.

The tax law has been amended to incorporate the above changes into the Cypriot tax legislation. The changes apply as of January 1, 2016.

THE SPECIAL CONTRIBUTION FOR THE DEFENSE OF THE REPUBLIC

The second revenue raising measure in Cyprus is the Special Defense Levy. It is a separate income tax imposed on certain dividends and interest.

The Special Defense Levy on interest income from investments has now increased from 15% to 30%, but this only applies to residents of Cyprus. Furthermore, interest received in the ordinary course of business is exempt from the Special Defense Levy.

Nonresident and tax resident but non-domiciled shareholders of Cyprus-resident companies are not subject to the Special Defense Levy.

Dividends paid from one Cyprus-resident company to another are exempt. Dividends received by a resident company from a nonresident are also exempt if (i) the investment income of the nonresident company is less than 50% of its total income, or (ii) the foreign tax burden is not substantially lower than the tax burden in Cyprus. This condition is met if either alternative is met. The term “substantially lower” is not defined within Cypriot law and is, therefore, left to the discretion of the tax authorities.

Penalties

New amendments impose much higher and stricter penalties for noncompliance with the provisions of the Special Contribution for the Defense of the Republic.

OTHER TAXES

Capital Gains Tax

Capital gains tax is not applicable to profits earned from the sale of securities but is applicable to real estate sales within Cyprus.

New Amendment – Capital Gains from the Sale of Shares in a Property Company

Currently, capital gains tax is charged on the disposal of immovable property located in Cyprus or on the disposal of shares of companies that directly own immovable property located in Cyprus.

Under the new legislation, the scope of capital gains tax is expanded. Consequently, gains from the sale of shares in a company that indirectly owns immovable property in Cyprus, by directly or indirectly holding of shares in a company that owns such property, will also be subject to capital gains tax. However, this tax will only apply if the value of the immovable property represents more than 50% of the value of the assets of the company whose shares are sold.

The change in the legislation can be illustrated as follows:

- Company A owns shares of Company B, which owns the shares of Company C, which in turn owns immovable property located in Cyprus.
- Currently, capital gains tax will arise if
  - Company C sells the immovable property, or
  - Company B sells the shares of Company C.
- Under the new legislation, capital gains tax will also arise if Company A sells the shares Company B.

In the case of the sale of shares of a company owning immovable property, the gain to be taxed will be calculated only based on the market value of the immovable property, which is held directly or indirectly.

Trading Gains from the Sale of Shares of Property Companies

Currently, if an entity is engaged in the sale of shares of companies such that the transactions are considered to be of a trading nature, any gains from the sale of such shares are exempt from income tax pursuant to the provisions of Cypriot income tax laws. Since these gains are not within the scope of capital gains tax law, the gains are tax-free, even if the shares being sold relate to a company that owns immovable property located in Cyprus.

Under the new legislation, these gains would remain exempt from income tax but would now be subject to capital gains tax.

Transactions Between Related Parties

In the case of the sale of property between related persons, the Tax Commissioner will have the right to replace the sale price declared by the parties concerned with the market value of the property sold, if, in his opinion, the selling price declared is lower than the market value.

Inheritance and Estate Taxes

There are no such taxes on shares held in a Cyprus company.

Thin Capitalization Rules

Cypriot tax law does not contain specific thin capitalization or transfer pricing rules. Nonetheless, transaction values in related-party transactions should be based on the "arm's length principle."

ARM'S LENGTH TRANSFER PRICING

Section 33 of the tax law provides specific rules to address business structures where

- a Cyprus business participates directly or indirectly in the management, control, or capital of a business of another person, or the same persons participate directly or indirectly in the management, control, or capital of two or more businesses; and
- commercial or financial relations between said businesses differ substantially from those that would exist between independent businesses.

Under these circumstances, any profits that would have accrued to one of the businesses in absence of these special conditions may be included in the profits of that business and be taxed accordingly.

This provision allows the Inland Revenue Department to adjust the profits of a resident company or other person for income tax purposes where it is of the opinion that, because of the special relationship between the Cyprus-resident person and the other party to a transaction, the Cyprus profits have been understated.

TAX REGISTRATION PROVISIONS

Regarding the obligation to register for a Tax Identification Code ("T.I.C.") in Cyprus, although a company should register itself with the Cyprus Tax Authorities, a legal framework did not previously exist for such registration or for noncompliance penalties.

Now, a company is obliged to submit the relevant return and obtain a T.I.C. within 60 days of the date of its incorporation. Failure to comply will now result in heavy fines.

EXCHANGE OF INFORMATION AND BANK CONFIDENTIALITY RULES

Cyprus is one of the "Early Adopters" of the Common Reporting Standard ("C.R.S."). Consequently, a decree based on the income tax laws was enacted in December 2015 and was amended in May 2016. The amended decree imposes the obligation upon Cypriot financial institutions to effect an automatic exchange of information through the Central Bank of Cyprus with all other jurisdictions that are signatories of the C.R.S. convention. Banks have already introduced new forms, which include the requirement for the provision of the tax residence I.D. numbers of ultimate beneficial owners ("U.B.O.'s").

Cyprus is a signatory of the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This is a multilateral agreement to exchange information and provide assistance on the basis of inquiries from one signatory state to another.

Consequently, if and when the Cyprus Tax Authorities receive an inquiry from the tax authority of another signatory state, Cyprus is obliged in practice to provide such information without resorting to the procedure described below, so long as certain conditions of the local legislation are satisfied. Fishing expeditions will not be permitted.

For inquiries not related to the C.R.S., the Director of Inland Revenue (the "Director") retains the right to request that a bank provide information it possesses in relation to any existing or closed bank account of a person under investigation within a period of seven years preceding the date of the request. Prior to making such a request, the Director must obtain written consent from the Attorney General ("A.G.") and furnish the person under investigation with a relevant written notice.

"Cyprus is one of the 'Early Adopters' of the Common Reporting Standard ('C.R.S.'). Consequently, a decree based on the income tax laws was enacted."

The Director must inform the A.G. of the tax purpose and the reasons for which the information is requested. In order to obtain consent from the A.G., the Director should apply directly to the A.G. and furnish both the A.G. and the bank with

- the identity of the person under examination;
- a description of the information requested, including the nature and manner in which the Director wishes to receive the information from the bank;
- the reasons which lead to the belief that the requested information is in the custody of the bank;
- the (specific and reasoned) period of time for which the information is requested; and
- a declaration that the Director has exhausted all means at his/her disposal to obtain the requested information, except where resorting to such means would have imposed an undue burden.

Furthermore, the Director must inform the person under investigation of the written consent, or the refusal of such consent, by the A.G. as soon as this information is made available.

Provision of Information by Civil Servants

The confidentiality bar on civil servants is now removed, and civil servants are now under the obligation to reveal to the tax authorities, upon request, any information they may have on taxpayers.

Bookkeeping and Field Audits

Following the provision of a reasonable notice to the interested party during a field audit, the Director is entitled to enter and inspect any business premises, building premises, or rooms (during business hours), except residential dwellings, including any goods and documents found in them.

MORE STRINGENT REQUIREMENTS FROM THE E.U. AND OTHER JURISDICTIONS

Various E.U. Member States and other jurisdictions now require more detailed explanations from clients using private Cypriot companies within their structures. Such disclosures include the length of time shares are held, copies of transaction documents, confirmation from the board of directors that the Cypriot company is managed and controlled in Cyprus, proof of the appropriate qualifications and experience of the directors, and evidence of an actual physical presence in Cyprus.

With planning, proper record keeping, and the adoption of rules regarding economic substance, corporate residents of Cyprus have successfully claimed treaty benefits from foreign tax authorities.

DOUBLE TAX TREATIES

Cyprus has developed an extensive network of double tax treaties that offer excellent opportunities for international tax planning for a wide range of businesses. Set out below is the table of jurisdictions.

Armenia	Austria	Bahrain	Belarus
Belgium	Bosnia & Herzegovina	Bulgaria	Canada
China	C.I.S.[1]	Czech Republic	Denmark
Egypt	Estonia	Finland	France
Georgia	Germany	Greece	Guernsey
Hungary	Iceland	India	Iran
Ireland	Italy	Jersey	Kuwait
Kyrgyzstan	Latvia	Lebanon	Lithuania
Macedonia	Malta	Mauritius	Moldova

[1] The treaty concluded between Cyprus and the former U.S.S.R. is applicable to Azerbaijan and Uzbekistan, Republics of the Commonwealth of Independent States ("C.I.S."), until such time they wish to abrogate the treaty.

Montenegro	Norway	Poland	Portugal
Qatar	Romania	Russia	San Marino
Serbia	Seychelles	Singapore	Slovakia
Slovenia	South Africa	Spain	Sweden
Switzerland	Syria	Tajikistan	Thailand
Turkmenistan	Ukraine	United Arab Emirates	United Kingdom
United States			

THE B.E.P.S. PROJECT – IMPLICATIONS FOR CYPRUS

As previously noted, the main tax provisions relating to Cypriot holding companies have recently been revised in light of E.U. directives and O.E.C.D. recommendations under the B.E.P.S. Project. The B.E.P.S. Project contains 15 specific actions. The impact of these actions on Cypriot tax law is detailed below.

B.E.P.S. Action 2

The effects of B.E.P.S. Action 2 have been discussed above in **Related-Party Transactions**.

B.E.P.S. Action 3

Although controlled foreign corporation ("C.F.C.") rules do not currently exist in Cyprus, amendments to Cypriot tax law are currently being discussed.

B.E.P.S. Action 4

B.E.P.S. Action 4 will likely affect Cypriot companies receiving interest income when the jurisdiction of residence of the debtor company introduces measures disallowing deductions for interest expense.

B.E.P.S. Actions 5 & 8

As previously discussed, the I.P. Box regime in Cyprus has become fully compliant with O.E.C.D. Guidelines with the adoption of the "nexus approach." Intangible assets must be developed in Cyprus in order to claim tax benefits. Benefits afforded under the prior regime will be phased out in 2021.

With the introduction of the nexus approach, it will be difficult for many international businesses to continue to take advantage of the Cypriot I.P. Box regime beyond the expiration of the grandfather period at the end of the year 2021. For the benefit to extend further, the Cypriot government must develop an incentive program beyond the adoption of a low tax rate for I.P. Box companies. Implementation of B.E.P.S. Actions 5 & 8 will make Cyprus an ideal location for the internal development of intangibles.

B.E.P.S. Action 6

A limitation of benefits ("L.O.B.") provision is expected to be included in new treaties concluded by Cyprus. The provision will deny treaty benefits to structures in which the Cypriot company does not maintain sufficient contact with Cyprus.

It is expected that pressure will be placed on Cyprus to amend existing double tax treaties to include an L.O.B. provision.

So far, structures under which income is reduced by the 80% notional interest deduction have withstood scrutiny. However, several E.U. countries have eliminated the provision.

Action Item 6 is likely to result in a considerable number of new treaty provisions. It is likely that Article 3 of a new model treaty will include a definition of "special tax regime" that provides a preferential tax rate for specific items of income, including a notional interest deduction. New provisions will likely be included in model Articles 11, 12, and 21 to deny lower treaty interest, royalties, or other income when a recipient benefits from low-tax regimes.

B.E.P.S. Action 10

Cypriot companies are often used to provide administrative services to intra-group companies. Following the implementation of B.E.P.S. Action 10, the Cypriot company must maintain the necessary infrastructure and substance to provide these services from a base in Cyprus. In particular, the Cypriot entity must demonstrate that it has incurred sufficient costs to justify a "cost plus" transfer price for services to intra-group companies. If real costs are not incurred, the fee will be reduced in the course of a tax examination in the jurisdiction of residence of the payer.

B.E.P.S. Action 13

On December 30, 2016, Order No. 401/2016 was issued by the Ministry of Finance of Cyprus adopting the provisions for Country-by-Country Reporting.

Every ultimate parent company of a multinational group of companies that is tax resident of Cyprus must submit a country-by-country report within 15 months of the end of its financial year.

The first report for the year 2016 must be submitted by June 30, 2018. The report must include the following information for each country (whether E.U. or non-E.U.) where the group is operating:

- Revenues
- Profits before taxation
- Tax actually paid and tax payable
- Issued share capital
- Accumulated reserves
- Number of employees
- Tangible assets (other than cash or cash equivalents)

An "ultimate parent company" is a company which meets the following criteria:

- The company holds, directly or indirectly, enough share capital in one or more other companies in the multinational group so that it is required to prepare consolidated financial statements in accordance with the accounting principles followed in the country in which it is resident.

- There is no other company in the multinational group that directly or indirectly holds share capital in the first company which would oblige such other company to prepare consolidated financial statements.

Under certain circumstances, a Cypriot tax resident holding company may be obliged to submit the report even if it is not the ultimate holding company.

Groups with gross annual consolidated revenues of less than €750 million are exempt from this obligation.

B.E.P.S. Action 15

Cyprus is a signatory to the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("M.L.I.") that is intended to implement a series of tax treaty measures in one fell swoop.

The M.L.I. will apply in cases where both states are party to the M.L.I. The M.L.I. will not apply where only one of the contracting states is a party to it.

It is anticipated that the effects of the M.L.I. will be felt by 2019. Each signatory country will have the opportunity to express its reservations to any provisions of found in the instrument.

New Transfer Pricing Rules in Cyprus for Financing

New transfer pricing rules for financing are expected to be outlined in a circular to be issued by the Tax Department once approval is received from the E.U. Commission.

The rules are expected to be similar to those published by Luxembourg on December 27, 2016, on the same subject.

MALTA

Author
Dr. Stefan P. Gauci
Sliema, Malta

GENERAL OVERVIEW OF BUSINESS FORMS AND RESPONSIBILITIES

Forms of Business

Malta is distinctive for its hybrid body of law, which blends traditional civil law and U.K. common law principles and has been further refined by E.U. regulations and directives. The result is a unique body of pragmatic law with international application.

The Companies Act envisages three forms of commercial arrangements as vehicles for conducting business: the partnership *en nom collectif*, the partnership *en commandite*, and the limited liability company.[1] Each has its own particular features and advantages. The first two arrangements have decreased in popularity and have been largely replaced by the limited liability company, which is made attractive by its limited liability for business owners and separate juridical personality.

Generally, the limited liability company – whether private exempt or private non-exempt, single-member or public – is the vehicle for conducting any kind of business activity without territorial limitation.

In addition, new legislation allows for the increased use of the S.I.C.A.V. and the I.N.V.C.O. for companies undertaking the provision of investment services:

- S.I.C.A.V. incorporated cell companies and recognized incorporated cell companies have been used in connection with structuring multi-class or multi-fund professional investment funds.
- The insurance sector regularly uses the protected cell company and the incorporated cell company as vehicles to conduct insurance and reinsurance business.
- Securitization cell companies have become increasingly common.[2] An infinite number of segregated cells may be established for the performance of securitization transactions. The assets and liabilities of each cell are considered to be contained separately and distinctly within that cell and are protected from the general assets of the securitization company and the assets and liabilities of the other cells. Cells are not vested with separate juridical personality, which is vested in the securitization company, itself. All cells are managed and administered

1 Since joining the E.U., Maltese company law offers a fourth type of vehicle, the European Economic Interest Grouping ("E.E.I.G."), but this option is not very popular and rarely used.

2 The number of securitization vehicles (whether cellular or non-cellular) has increased from under ten in 2015 to 34 by the end of 2016. Regarding cells, eleven were created in 2016 compared to a single cell created in 2015.

by the board of directors or by holders of special mandates to manage and administer the securitization transaction executed by a particular cell.

Capital Contribution Taxes

A company is incorporated in accordance with the provisions of the Companies Act by registering its memorandum and articles of association with the Registry of Companies. Maltese law does not prescribe any capital taxes upon incorporation, but does provide for a company registration fee, payable on the basis of the authorized share capital of the company. The fee ranges from a minimum of €245 to a maximum of €2,250.

In order to maintain corporate good standing, the directors of the company are obligated to submit an annual return in compliance with the Companies Act provisions. The return is filed on each anniversary of the company's incorporation. The annual return must be accompanied by an annual return fee, which ranges from €100 to €1,400, depending on the company's authorized share capital. Lower registration fees are imposed if the incorporation documents and annual return are submitted electronically.

Governance and Responsibilities

The management of a Maltese company rests with its board of directors. Members of the board may be individuals or corporate entities. Directors are not required to be resident in Malta. However, companies engaging in licensed activities, such as the provision of investment services, the appointment of Maltese-resident directors is required by the Malta Financial Services Authority ("M.F.S.A.").

The M.F.S.A. has issued corporate governance guidelines with respect to the management of public companies, listed companies, investment companies, and collective investment schemes. The guidelines are intended to promote a desired standard for members sitting on the board of directors of such companies. For private companies, the guidelines represent best practices and are recommended for the management and administration of larger private companies.

The directors of a Maltese company are personally responsible for the company's compliance with Maltese tax law and are personally liable for taxes owed by the company. Although court decisions vary, the prevalent view is that all officers are obligated to ensure that the company is compliant with the Value Added Tax Act. Responsibility extends to all directors and officers of a company, including the company secretary and persons occupying managerial positions. Comparable liability is also imposed on the liquidator of a company.

Identical obligations are imposed upon the directors with regards to the registration of employment contracts and the fulfillment of monthly and annual social security compliance requirements.

Audit Requirements

In Malta, the preparation of mandatory audited financial statements is regulated by the Companies Act, the Maltese Income Tax Acts, and the Accountancy Profession Act. Financial statements are prepared in accordance with the International Financial Reporting Standards or under Maltese Generally Accepted Accounting Principles, as permitted by the Accountancy Profession Act and subsidiary legislation issued thereunder focusing on small- and medium-sized enterprises ("S.M.E.'s").

Generally, all companies are subject to a mandatory audit of their annual reports and financial statements. However, stand-alone "small companies"[3] and "small groups"[4] of companies are not required to have their financial statements audited, although the Income Tax Acts may require audited financial statements in specific circumstances.

As a rule, the Companies Act requires the preparation of consolidated accounts whenever a Maltese company is the parent of a subsidiary, regardless of where the registered offices or principal offices of the subsidiaries are located. Certain exemptions apply to (i) private exempt companies, and (ii) single-member companies.

Specific Industry Incentives

The Maltese Aircraft Registry was launched in 2010, building on the success of the Maltese Shipping Registry. Favorable rules exist with regards to income tax, tonnage tax, and V.A.T. for yacht-leasing operations, short-term yacht chartering, and aircraft-leasing arrangements.

Specific fiscal incentives launched by the Maltese government in various business sectors include tax exemptions for royalty income derived from the exploitation of patents, copyrights, and trademarks registered in the name of a Maltese-resident company. The exemption for royalty companies is part of a government program to transform Malta into an intellectual property hub. The exemption applies to gaming companies operating from a base in Malta.

"Malta provides fiscal incentives to individuals who relocate to Malta for the purposes of employment under a qualifying contract in eligible offices. This includes a 15% flat rate taxation for income derived from a qualifying contract."

Malta provides fiscal incentives to individuals who relocate to Malta for the purposes of employment under a qualifying contract in eligible offices.[5] This includes a 15%

---

[3] Pursuant to Article 185(1) of the Companies Act, small companies cannot exceed two of the following thresholds, as reported on their balance sheets: (i) a balance sheet total of €2,562,310.74, (ii) a turnover of €5,124,621.48, and (iii) an average number of employees during the accounting period of 50; and small private companies cannot exceed two of the following thresholds: (i) a balance sheet total of €46,587.47, (ii) a turnover of €93,174.94, and (iii) an average number of employees during the accounting period of 2.

[4] Pursuant to Article 185(1) of the Companies Act, small groups of companies cannot exceed any of the following thresholds: (i) an aggregate balance sheet total of €2,562,310.74 net or €3,074,772.89 gross, (ii) an aggregate turnover of €5,124,621.48 net or €6,149,545.77 gross, and (iii) an aggregate number of employees of 50.

[5] Pursuant to the Highly Qualified Persons Rules (Subsidiary Legislation 123.126), qualifying employment includes employment with companies licensed and/or recognized by the competent authority or with undertakings holding an air operators' certificate issued by the competent authority such as Chief Executive Officer, Chief Risk Officer (including Fraud and Investigations Officer), Chief Financial Officer, Chief Operations Officer (including Aviation Accountable Manager), Chief Technology Officer, Chief Commercial Officer, Portfolio Manager, Chief Investment Officer, Senior Trader/Trader, Senior Analyst (including Structuring Professional), Actuarial Professional, Chief Underwriting Officer, Chief Insurance Technical Officer, Odds Compiler Specialist, Head of Research and Development (including Search Engine Optimization and Systems Architecture), Aviation Continuing Airworthiness Manager, Aviation Flight Operations Manager, Aviation Training Manager, and Aviation Ground Operations Manager, Head of Marketing (including Head of Distribution Channels), or Head of Investor Relations; and employment with undertakings holding an aerodrome license issued by the competent authority, consisting of employment as Chief Executive Officer. Pursuant to the Qualifying Employment in Innovation and Creativity (Personal Tax) Rules of Subsidiary Legislation 123.141, which shall remain in force until December 31, 2014 (unless further extended), roles directly engaged in industrial research, experimental development, product development, product design, product or process innovation, or senior management are included.

flat rate taxation for income derived from a qualifying contract.

Through Malta Enterprise, fiscal and business assistance is provided to businesses that establish factories on Maltese territory for production activities in sector-specific industries and for research and development.

Malta is a center for international credit institutions that operate as limited liability companies registered under the provisions of the Companies Act and licensed under the Maltese Banking Act by the M.F.S.A. These entities conduct business across the E.U. and the local legislation is compliant with E.U. directives, including the Markets in Financial Instruments Directive ("M.i.F.I.D."), the Alternative Investment Fund Managers Directive ("A.I.F.M.D."), the European Market Infrastructure Regulations ("E.M.I.R."), and their variations promulgated from time to time.

TAXATION OF COMPANY PROFITS

Unless an exemption from tax or a special fiscal regime applies to a company as a result of industry-specific or license-specific tax incentives under Maltese law, companies registered in Malta are generally taxed at the flat rate of 35%.

However, the Income Tax Acts allow for certain types of income to be taxed separately at the source. Included are (i) bank interest, which may be taxed at the source at the rate of 15% upon an election to that effect by the taxpayer, and (ii) gains from a real property transfer, when performed as a one-off transaction and not by a company whose trade is real property speculation, where a withholding tax of 8%, calculated on the value of the property transferred is the final tax.

A few exceptions may also result in different tax rates, ranging between 2% and 10%,[6] depending on the circumstances of the particular case.

The tax is levied on the taxable income of a company earned in the fiscal year being assessed, after accounting for deductible expenses that are wholly and exclusively incurred in the production of the income. Losses from prior years may be carried forward to offset the profits of the current year. Capital losses may not offset operating profits. Such losses may be used only to offset capital gains.

Malta applies the full imputation system of taxation, meaning that tax paid by a company is allowed as a credit when dividends are received by its shareholders.

Upon written request, companies that are in compliance with their taxing obligations may be furnished with a Fiscal Residence Certificate issued by the Commissioner for Revenue, proving their fiscal good standing in accordance with Maltese law.

TAX ACCOUNTING

Profits generated by a company are allocated to the final taxed account, foreign

---

6 The 12% tax on property transfers will continue to be applicable with respect to promise of sale agreements registered with the Commissioner for Revenue prior to November 17, 2014. Transfers of inherited immovable property will remain subject to a 12% final tax on the difference between the transfer value and the cost of acquisition, and to a 7% final tax on the consideration, if inherited before November 25, 1992.

income account, immovable property account, the Maltese taxed account, or the untaxed account, depending on the revenue streams flowing into the company. The allocation of profits to these accounts is relevant when considering the distributions made by the company and, in particular, when a shareholder who has received a dividend files an application for a tax refund. Distributions are to be made in the following order of priority: (i) profits allocated to the final tax account, (ii) profits allocated to the immovable property account, (iii) distributions from the foreign income account, and (iv) profits allocated to the Maltese taxed account.

The allocation of profits is classified as follows:

- **Final Taxed Account.** The profits allocated to this account consist of income that, in accordance with the provisions of the Income Tax Acts, is subject to a final withholding tax or upon which no further tax is payable. The full imputation system does not apply to the final taxed account. Distributions from the final taxed account are not subject to further tax.

- **Immovable Property Account.** The profits allocated to the immovable property account consist of income that is derived from immovable (real) property situated in Malta. Such profits include, *inter alia*, gains on the sale of property, rents, interest on loans to finance the acquisition of property situated in Malta, income from hotel accommodations, insurance premiums related to property situated in Malta, and any other income which is connected to Maltese immovable property. It also includes a notional allocation in those instances where the property is owned by a company and is used for the purposes of its business activities (notional rent).

- **Foreign Income Account.** The profits allocated to this account consist of income from sources outside Malta and include, *inter alia*, royalties, dividends, capital gains, interest, rents, income derived from participating holdings, profits attributable to a permanent establishment outside of Malta, and income from investments held outside Malta.

- **Maltese Taxed Account.** The profits allocated to the Maltese taxed account have been subject to tax already, generally at the rate of 35%. It also includes profits on which a lower rate of tax has been applied.

- **Untaxed Account.** The allocation to this account represents the arithmetical difference between the total profits earned by the company and those that are allocated to the various other tax accounts. Distributions out of the untaxed account are subject to a 15% withholding tax if the recipient is a Maltese-resident individual. On the other hand, non-resident individuals and Maltese-resident companies fall outside the definition of “recipient” and, in the case of such distributions, withholding tax is not applicable.

MALTESE REFUNDABLE TAX SYSTEM

The Maltese refundable tax system, as approved by the E.U., offers a significant advantage because when a company distributes its profits, all shareholders receiving the dividends are entitled to a refund of the tax paid by the company. Nonresident status is not a relevant factor in determining entitlement to the refund. The amount of the refund depends on the nature of the income and the manner in which the income has been allocated to the different tax accounts. The various types of refunds and the circumstances under which they apply are illustrated hereunder:

- **Six-Sevenths Refund.** The six-sevenths refund is applicable to distributions made from profits allocated to the Maltese taxed account or to the foreign income account where such income does not consist of passive income or royalties.

- **Five-Sevenths Refund.** The five-sevenths refund applies to distributions of profits derived from passive interest, royalties, and dividends received from participating holdings that do not meet the anti-abuse provisions.

- **Full Refund.** Shareholders may apply for a full refund of the Maltese tax paid by the company in those instances where a dividend has been paid from profits derived from income received in connection to a participating holding. When such income qualifies for the participation exemption, the company receiving the income may exclude it from the income tax computation. In this instance, such income will be allocated to the final tax account, and no further tax will arise on the distribution of income allocated to this account when paid to nonresidents of Malta.

"Malta was and has consistently been transparent about its tax system: It is aimed at creating an attractive system that provides comparable benefits to domestic and foreign investors."

Malta's tax system has been under attack in a series of articles published recently in the international press. The articles refer to data obtained from publicly available sources and leaked information. The data portrays Malta as an offshore tax haven due to its full imputation system of taxation.

The Maltese system of taxation has been the subject of lengthy and detailed discussions with the European Council and the Director-General for Competition regarding State Aid. It has also been discussed with the E.U. Member States within the Code of Conduct Group, consisting of representatives from the Finance Ministries and tax authorities of various Member States. The Code of Conduct Group identifies tax measures that are harmful under the Code of Conduct for business taxation. In the report submitted to the Economic and Financial Affairs Council ("E.C.O.F.I.N.") in November 2016, the Code of Conduct Group concluded that the Maltese tax system is not harmful. Malta was and has consistently been transparent about its tax system: It is aimed at creating an attractive system that provides comparable benefits to domestic and foreign investors.

In addition, the European Council has not brought any cases against Malta related to a violation of the "four freedoms" or the principle of nondiscrimination. Malta has fully implemented and complied with all of the E.U.'s tax directives, which are unanimously approved by the Member States in E.C.O.F.I.N, and the Maltese tax system has not been found to infringe on the E.U.'s State Aid rules.

Globally, Malta has applied all O.E.C.D. initiatives to combat tax evasion, including the directives on mutual assistance between tax authorities, automatic exchanges of information, and the exchange of tax rulings and advance pricing arrangements in the field of transfer pricing. Malta is also an early adopter of the Common Reporting Standards and Country-by-Country Reporting obligations. Under Phase II of the O.E.C.D.'s Peer Reviews, Malta has been classified as "largely compliant" in matters of transparency and exchange of tax information. The United Kingdom, Germany, the Netherlands, and Italy received comparable clarification.

In June 2016, together with other Member States in E.C.O.F.I.N., Malta approved the Anti-Tax Avoidance Directive ("A.T.A.D."). Throughout its presidency of the

European Commission, all Member States gave approval for the A.T.A.D. 2 in February 2017.

In sum, the debate revolves around the morality of setting up companies in a low-tax E.U. jurisdiction.[7] These issues have already been addressed in detail by the E.C.J. in the *Cadbury Schweppes* decision. The E.C.J. held that anti-avoidance provisions such as controlled foreign corporation ("C.F.C.") provisions cannot hinder the fundamental freedom of establishment of the E.U., and that profits of a subsidiary in another Member State with a lower rate of taxation can only be taxed in the country of residence of the parent company if the subsidiary is wholly artificial.

PARTICIPATION EXEMPTION

Any income or gains derived by a Maltese-registered company from a participation in a company or from the transfer of a company qualifying as a participation is exempt from tax.

With respect to a dividend from a participation in a subsidiary, this exemption applies only when either of the following conditions are satisfied:

- The body of persons in which the participating holding is held satisfies any one of the following conditions:
    - It is a resident of or incorporated in an E.U. Member State.
    - It is subject to foreign tax at a rate of at least 15%.
    - It does not derive more than 50% of its income from passive interest or royalties.
- If none of the above conditions are satisfied, then *both* of the following conditions must be met in order to qualify for the exemption:
    - The equity holding is not a portfolio investment.[8]
    - The passive interest, or its royalties, have been subject to foreign tax at a rate which is not less than 5%.

An investment qualifies as a participation where any of the following conditions are met:

- A company holds directly 10% or more of the equity of a company whose capital is wholly or partly divided into shares, and the shareholding confers

[7] It is of utmost interest that one particular case which received a significant amount of attention in the media was that of an Italian politician who had failed to disclose to the Italian tax authorities that he was a shareholder (in his own name) and director of two Maltese-registered companies – information that was in the public domain and easily accessible. The Italian politician resigned from his post within hours of the Italian media coverage of these facts, which were more pertinent to the Italian tax authorities' interest in their combat against tax evasion than anything else.

[8] For this purpose, the holding of shares by a Maltese-resident company in a company not resident in Malta that derives more than 50% of its income from portfolio investments is itself deemed to be a portfolio investment.

an entitlement to at least 10% of any two of the following:

- Voting rights
- Profits available for distribution
- Assets available to shareholders upon liquidation

- A company is a shareholder in another company (the "target company") and is entitled, at its option, to acquire the entire balance of the issued and outstanding shares in the other company.
- A company is a shareholder in the target company and holds a right of first refusal over all shares in the target company that are owned by others in the event of a proposed disposal, redemption, or cancellation.
- A company is a shareholder in the target company and is entitled to board participation.[9]
- A company is a shareholder in the target company and the value of its investment is at least €1,164,000 at the time of purchase. The investment must be held for at least 183 consecutive days.
- A company is a shareholder in the target company where the investment was made for the furtherance of its own business and the holding is not maintained for the purposes of a trade.

OTHER EXEMPTIONS

Other exemptions apply, the most important of which include the following:

- **Permanent Establishment.** Income or gains derived by a company resident in Malta are exempt from Maltese taxation if attributable to a permanent establishment situated outside of Malta. The exemption covers income from ongoing operations and gain from a sale of the assets of the permanent establishment. For purposes of the exemption, "profits or gains" shall be calculated as if the permanent establishment is an independent enterprise operating in similar conditions and at arm's length.[10]
- **Intellectual Property.** Royalties, advances, and similar income derived from patents, copyrights, or trademarks are exempt from tax in Malta. Profits from exempt income remain exempt at the level of shareholders when distributed by way of a dividend. The exemption continues as dividends are distributed through a chain of shareholders.

---

[9] To be considered a participation, the right to nominate members of the board of directors should be a majority right.

[10] If, in the opinion of the Commissioner, a series of transactions is effected with the main purpose of reducing the income tax liability of any person through the operation of the permanent establishment exemption, that a person is assessable as if the exemption did not apply. A series of transactions means two or more corresponding or circular transactions carried out by the same person, either directly or indirectly, as the case may be.

WITHHOLDING TAXES ON DIVIDENDS DISTRIBUTED

No withholding taxes are levied on dividend distributions to a nonresident shareholder, provided that the shareholder is not directly or indirectly owned and controlled by, and does not act on behalf of, an individual who is ordinarily resident and domiciled in Malta.

WITHHOLDING TAXES ON INTEREST PAID

No withholding taxes are levied on interest payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the interest is effectively connected therewith. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

WITHHOLDING TAXES ON ROYALTIES PAID

No withholding taxes are levied on royalty payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the royalty payment is effectively connected with that permanent establishment. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

TRANSFERS OF SHARES IN A MALTESE COMPANY

Malta imposes a stamp duty on transfers of shares in a Maltese company. However, an exemption applies to transfers of shares in a Maltese company in which (i) more than 50% of the ordinary share capital, voting rights, and rights to profits are held by persons not resident in Malta or by the trustee of a trust in which all beneficiaries are nonresident with regard to Malta, and (ii) ownership or control is not held, directly or indirectly, by persons resident in Malta. No capital gains tax is due on a transfer by nonresidents. The exemptions do not apply if the company owns immovable property in Malta.

Similar exemptions from stamp duty and income tax liability apply when the value of the ownership is shifted from one shareholder to another shareholder by way of the issuance of shares by the company. The value of the ownership is represented by the percentage share capital held or the voting rights held in the company. In terms of Maltese law, these are considered as deemed transfers.

DOUBLE TAXATION RELIEF

With respect to the Income Tax Acts, relief from double taxation may take one of three forms: (i) treaty relief, (ii) unilateral relief, or (iii) flat rate foreign tax credit.

Treaty Relief

Treaty Relief is available if all the following criteria are satisfied:

- Under the relevant double tax treaty, the foreign tax paid in the other state is allowed as a credit against tax payable in Malta.
- The foreign tax is of a similar character to the tax imposed in Malta.
- The person making the claim is a resident of Malta during the year immediately preceding the year of assessment, and tax is payable on such income.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Malta's double tax treaty network is made up of treaties in force with more than 70 states, listed below. These treaties are by and large modeled after the O.E.C.D. Model Convention provisions and treaty interpretations as per the Commentaries.

Albania	Australia	Austria	Bahrain
Barbados	Belgium	Bulgaria	Canada
China	Croatia	Cyprus	Czech Republic
Denmark	Egypt	Estonia	Finland
France	Georgia	Germany	Greece
Guernsey	Hong Kong	Hungary	Iceland
India	Ireland	Isle of Man	Israel
Italy	Jersey	Jordan	Kuwait
Latvia	Lebanon	Libya	Liechtenstein
Lithuania	Luxembourg	Malaysia	Mauritius
Mexico	Moldova	Montenegro	Morocco
Netherlands	Norway	Pakistan	Poland
Portugal	Qatar	Romania	Russia
San Marino	Saudi Arabia	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sweden	Switzerland	Syria
Tunisia	Turkey	United Arab Emirates	United Kingdom
United States	Uruguay	Vietnam	

A double tax treaty has also been signed with the Ukraine (September 4, 2013), but it has not yet entered into force. Treaties are currently in various stages of negotiation with Bosnia and Herzegovina, Oman, and Thailand. A protocol on the exchange of information with regards to the treaty in force between Malta and Belgium was signed on January 19, 2010, but as of this publication it is still pending ratification and entry into force.

Malta has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

Unilateral Relief

In order to claim unilateral relief, the following conditions must be met:

- Treaty relief is not available to the person making the claim.
- The income in question arises outside of Malta and is subject to tax in the state of its source.
- The foreign tax is of a similar character to the tax imposed in Malta.
- The person entitled to the income is resident in Malta, or is a company registered in Malta for the year immediately preceding the year of assessment, and tax is payable on such income.
- The person making the claim proves to the satisfaction of the Commissioner of Inland Revenue that the foreign income has borne foreign tax and proves the amount of the tax.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Flat Rate Foreign Tax Credit

The Flat Rate Foreign Tax Credit is available if the following conditions are met:

- Treaty relief and unilateral relief are not available to the person making the claim.
- Income or gains are received by a company registered in Malta, which includes a Maltese branch of a nonresident company.
- The company is empowered to receive such income or gains.
- The income or gains are allocated to the foreign income account.
- Documentary evidence is made available that is satisfactory to the Commissioner for Revenue that the income or gains are to be allocated to the foreign income account.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

B.E.P.S. AND OTHER INITIATIVES

Malta actively participates in initiatives against harmful tax competition, which includes cooperation in foreign tax-related matters. It was one of the first states to enter into an intergovernmental agreement with the United States to allow for the implementation of F.A.T.C.A.[11] Maltese implementation of the F.A.T.C.A. provisions

---

[11] Malta and the U.S. signed a Model 1 I.G.A. on December 16, 2013.

was published on March 7, 2014.[12] The first exchanges between the two states under the I.G.A. took place in the third quarter of 2015.

Malta is also an active participant in the B.E.P.S. Project. It is a member of the *ad hoc* group of countries mandated by the O.E.C.D. and the G-20 in February 2015 to complete work on B.E.P.S. Action 15, which addresses the development of a multilateral instrument on tax treaty matters. Progress towards this deliverable began in Paris on May 27, 2015, and focused on the adoption of recommended procedures for onboarding customers.

Following the implementation of a 2010 protocol amending the Joint Council of Europe/O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters, Malta ratified the amended convention on May 23, 2013. The Amended Convention was adopted into Maltese law and became effective on September 1, 2013.

The E.U. Administrative Cooperation Directive (Council Directive 2011/16/E.U. of February 15, 2011 on administrative cooperation in the field of taxation) was adopted into Maltese law effective July 22, 2011.

Malta is an early adopter of the Common Reporting Standard and is expected to submit its first report by the end of June 2017, focusing on the financial year ending on December 31, 2016.

Malta signed an Exchange of Information Agreement with Macau (signed on May 30, 2013, but not yet in force). Other agreements already in force include the Bahamas (January 15, 2013), Bermuda (November 5, 2012), the Cayman Islands (April 1, 2014), and Gibraltar (June 12, 2012).

CONCLUSIONS APPLICABLE TO MALTA

The legal framework in Malta offers several key advantages for those seeking to conduct international business in a sound and reputable jurisdiction.

Maltese transfer pricing rules are relatively flexible. Maltese income tax law contains no thin capitalization rules or C.F.C. rules, although specific legislation in regard to the latter will be enacted under directives issued by the European Commission. Several anti-abuse rules are contained in Article 51, designed to combat artificial and fictitious schemes.

The legislation in Malta permits companies to migrate to and from Malta as long as certain minimum requirements are fulfilled. Branches of overseas companies enjoy the same tax treatment applicable to companies incorporated in Malta. Incorporation and winding up procedures are relatively easy and in general quite expeditious.

[12] See Exchange of Information (United States of America) (F.A.T.C.A.) Order, Legal Notice 78 of 2014.

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

The private client group of the firm also advises clients on matters related to domestic and international estate planning, charitable planned giving, trust and estate administration, and executive compensation.

The tax practice is supported by our corporate group, which provides legal representation in mergers, licenses, asset acquisitions, corporate reorganizations, acquisition of real property, and estate and trust matters. The firm advises corporate tax departments on management issues arising under the Sarbanes-Oxley Act.

Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

Disclaimer

Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

NEW YORK

150 EAST 58TH STREET, 22ND FLOOR, NEW YORK, NY 10155

Galia Antebi	antebi@ruchelaw.com	+1 212.755.3333 x 113
Beate Erwin	erwin@ruchelaw.com	+1 212.755.3333 x 116
Fanny Karaman	karaman@ruchelaw.com	+1 212.755.3333 x 127
Nina Krauthamer	krauthamer@ruchelaw.com	+1 212.755.3333 x 118
Jennifer Lapper	lapper@ruchelaw.com	+1 212.755.3333 x 124
Andrew P. Mitchel	mitchel@ruchelaw.com	+1 212.755.3333 x 122
Simon H. Prisk	prisk@ruchelaw.com	+1 212.755.3333 x 114
Neha Rastogi	rastogi@ruchelaw.com	+1 212.755.3333 x 131
Stanley C. Ruchelman	ruchelman@ruchelaw.com	+1 212.755.3333 x 111
Rusudan Shervashidze	shervashidze@ruchelaw.com	+1 212.755.3333 x 117
Francesca York	york@ruchelaw.com	+1 212.755.3333 x 125
Elizabeth V. Zanet	zanet@ruchelaw.com	+1 212.755.3333 x 123

TORONTO

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

Michael Peggs	peggs@ruchelaw.com	+1 212.755.3333 x 232

Editorial Staff

Jennifer Lapper .... Managing Editor, Art Director
Francesca York .... Graphics Editor, Copyeditor

PHOTOS IN THIS ISSUE WERE TAKEN BY:
Galia Antebi, Philip Hirschfeld, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.