



# INSIGHTS

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## OUTBOUND ACQUISITIONS: TAX PLANNING FOR EUROPEAN EXPANSION IN A CHANGING LANDSCAPE (2022)

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### About Us

## EDITORS' NOTE

The Summer Edition of *Insights* is devoted to a holistic examination of cross border tax planning for U.S. companies expanding into Europe. Historically, these plans followed a road map designed to deconstruct business operations, placing production, financing, and I.P. functions in separate group companies based in different countries. If the road map were carefully followed, European taxes on operations could be driven down in ways that did not result in immediate U.S. taxation under Subpart F. Large U.S. based multinationals became expert in navigating the road map.

Events beginning in 2015, picking up speed in 2017, and carrying through to 2022 make it unrealistic to believe that old planning strategies still yield benefits. Too many barriers now exist and more will come online annually.

- The first barrier consists of the actions taken by the O.E.C.D. to curtail base erosion and profit shifting through the B.E.P.S. Project.
- The second barrier is a never-ending stream of directives issued by the European Commission and proposals by the European Parliament attacking various tax plans involving affiliated companies and their beneficial owners, with the intent of exposing tax plans to name-and-shame attacks by stakeholders such as nongovernmental organizations and crusading journalists. The latest iteration in the attack on “sharp” planning is A.T.A.D. 3, the “unshelling directive.”
- The third barrier consists of several decisions of the European Court of Justice, known as the “Danish Cases,” judicially mandating that all plans must reflect economic substance and business purpose in order to be effective. The target consisted of shell entities having as their only function the receipt of dividends and interest from subsidiaries based in Member States of the E.U. and the payment of dividends and interest equivalents to related parties outside the E.U. The holding effectively adopts the decision in an old U.S. Tax Court case, *Aiken Industries, Inc. v. Commr.*
- The fourth barrier is D.A.C.6, a European Council Directive on Administrative Cooperation, imposing reporting obligations on intermediaries who advise clients or provide services in support of cross-border tax arrangements containing certain hallmarks of abusive tax planning.
- The fifth barrier consists of Pillar 1 and Pillar 2 proposed by the O.E.C.D. in support of the B.E.P.S. project, which proposes to adjust taxing rights of countries touched by large digital businesses and to impose a global minimum tax. At the present time, there is much “jaw boning” about the Pillars, but the degree of traction remains an open question.

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

- The adoption of a dividends-received deduction for intercompany dividends received from a foreign subsidiary meeting a ≥10% ownership threshold. The deduction replaces the indirect foreign tax credit available to corporations

receiving dividends from  $\geq 10\%$  subsidiaries.

- The imposition of mandatory gain recognition for outbound transfers of property that will be used in an active trade or business conducted outside the U.S. by a foreign subsidiary.
- The adoption of G.I.L.T.I. provisions on income of controlled foreign corporations. Under prior law, income not taxed immediately under Subpart F benefitted from indefinite deferral of tax in the U.S.
- Attacks on cross-border hybrid transaction among related C.F.C.'s.

The 2022 Summer Edition of *Insights* addresses the broad range of impediments that must be overcome in planning cross-border operations. It begins with a detailed overview of post-T.C.J.A. U.S. tax law, comparing old rules with new realities, and a general preview of revisions proposed by the current Administration in the U.S. From there, B.E.P.S. provisions applicable on a global basis are addressed, as are Pillar 1 and Pillar 2. It is followed by a discussion of European attacks on illegal State Aid and abusive tax planning. Several embarrassing losses for the European Commission are discussed, as is an important win for the Danish tax administration and an amendment to A.T.A.D. that attacks shell companies. It concludes with detailed explanations of corporate tax rules in 16 European jurisdictions by recognized experts in the respective countries.

In sum, the 2022 Summer Edition of *Insights* reflects the current state of acceptable corporate tax planning for European expansion as of its publication in 2022.

We hope you enjoy this issue.

- The Editors



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## AUTHOR CONTACTS

### **JOÃO LUÍS ARAÚJO**

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

### **GUILLERMO CANALEJO LASARTE**

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

### **MICHEL COLLET**

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

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

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

### **ERIC FORT**

Arendt & Medernach  
*New York, U.S.A.*  
[eric.fort@arendt.com](mailto:eric.fort@arendt.com)

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

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

### **WERNER HEYVAERT**

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

### **STEPHAN NEIDHARDT**

Stephan Neidhardt A&S  
*Zürich, Switzerland*  
[stephan.neidhardt@walderwyss.com](mailto:stephan.neidhardt@walderwyss.com)

### **ERIK NILSSON**

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

### **ARNE RIIS**

BDO Denmark  
*Copenhagen, Denmark*  
[ari@bdo.dk](mailto:ari@bdo.dk)

### **LUCA ROSSI**

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

### **STANLEY C. RUCHELMAN**

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

### **MATTHIAS SCHEIFELE**

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

### **JAMES SOMERVILLE**

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

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

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

### **SJOERD STOKMANS**

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

### **FRANK VAN KUIJK**

Loyens & Loeff  
*Luxembourg*  
[frank.van.kuijk@loyensloeff.com](mailto:frank.van.kuijk@loyensloeff.com)

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

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

### **ELOISE WALKER**

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



# INTRODUCTION

## Author

Stanley C. Ruchelman  
Ruchelman P.L.L.C.  
New York

This chapter of the article was written by Stanley C. Ruchelman of Ruchelman P.L.L.C., New York.

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## GLOBAL TAX PLANNING IN A PRE-2018 WORLD

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

### Reduction of Taxes in Europe

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

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

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

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

- Make check-the-box elections for DCO and OPCO so that both are treated as branches of TOPCO.
- Have TOPCO license the rights previously obtained under the qualified cost sharing agreement to DCO and have DCO enter a comparable license agreement with OPCO.

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

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

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

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

Although the foreign tax credit has often been described as a "dollar-for-dollar reduction of U.S. tax" when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality has been quite different. Only taxes that were imposed on items of "foreign-source taxable income" could be claimed as credits.<sup>1</sup> This rule, known as "the foreign tax credit limitation," was intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S.-taxable income. The U.S., as with most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income.

The foreign tax credit limitation was structured to prevent so-called "cross crediting," under which high taxes on operating income could be used to offset U.S. tax on lightly taxed investment income. For many years, the foreign tax credit limitation was applied separately with regard to eight different categories, or baskets, of income designed to prevent the absorption of excess foreign tax credits by low-tax foreign-source income. In substance, this eviscerated the benefit of the foreign tax

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

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

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

Additionally, the foreign tax credit was reduced for dividends received by U.S. citizens and resident individuals from foreign corporations that, in the hands of the recipient, benefited from reduced rates of tax in the U.S. A portion of foreign dividends received by U.S. individuals that qualify for the 0%, 15%, or 20% tax rate under Code §1(h)(11)(B)(i) was removed from the numerator and denominator of the foreign tax credit limitation to reflect the reduced U.S. tax rate imposed on those items.<sup>2</sup> This treatment reduced the foreign tax credit limitation when a U.S. citizen or resident individual received both qualifying dividends from a foreign corporation – subject to low tax in the U.S. – and other items of foreign-source income within the same basket – subject to much higher ordinary tax rates. Another reduction in foreign source gains applied when U.S. source losses reduced foreign source gains. The goal of the provision was to eliminate a double benefit for the taxpayer regarding foreign source gains in that fact pattern. The first benefit was use of a domestic loss to reduce the foreign gain when computing taxable income. The second benefit was the elimination of U.S. tax due by reason of the foreign tax credit.<sup>3</sup>

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

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

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

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

<sup>3</sup> Code §904(b)(2)(A).

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

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

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

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

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

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

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

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

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

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

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

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

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

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<sup>10</sup> Code §904(f).

<sup>11</sup> Code §7874(a)(1).

<sup>12</sup> Code §7874(a)(2)(B).

<sup>13</sup> Code §7878(b).

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

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

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



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<sup>14</sup> Treas. Reg. §1.7874-7.

<sup>15</sup> Treas. Reg. §1.7874-8.

<sup>16</sup> Treas. Reg. §1.7874-9.

<sup>17</sup> Treas. Reg. §1.7874-10.

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

<sup>19</sup> Treas. Reg. §1.7874-12T.

<sup>20</sup> Treas. Reg. §1.304-7T.

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

## GLOBAL TAX PLANNING IN A POST-2017 WORLD

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

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

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

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

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

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

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

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

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

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

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

*“For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than just tax residence in a particular country. . .”*

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

For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than just tax residence in a particular country – it should conduct group functions in that country and be ready to provide evidence of the activities performed. These challenges within Europe should be compared with the approach to substance that is found in the limitation on benefits articles of U.S. income tax treaties. Objective standards are typically provided under which substance is judged to exist. In addition, ongoing business activities of a group member can be attributed to related parties. In particular, the active trade or business provision of most limitation on benefits articles allows intermediary holding companies to be viewed as active participants in a business if they own at least 50% of a subsidiary or partnership that has active business operations. These provisions eliminate intra-European challenges of tax authorities and may incentivize direct investment.

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

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

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

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

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

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

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

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

In 2021, the O.E.C.D. proposed Pillar 1 and Pillar 2. According to the O.E.C.D., Pillar 1 reallocates the profits of about 100 of the world's largest and most profitable multinational enterprises to market jurisdictions. For a targeted company, Pillar 1 expands the taxing rights of market jurisdictions to collect tax from the targeted enterprise, regardless of physical presence. Not covered by Pillar 1 are companies in the extractives sector, such as oil, gas, and mining companies. Also excluded are regulated companies operating in the financial services sector.

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

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

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



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

### Attacks Based on State Aid

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

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

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

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

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

- Hybrid financial instrument mismatches
- Hybrid entity mismatches

<sup>27</sup>

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### Cross-Border Intercompany Dividends Received Deduction

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

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

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

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

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

<sup>29</sup> Code §245A.

<sup>30</sup> Code §245A(e)(2).

<sup>31</sup> Code §245A(e)(3).

<sup>32</sup> Code §904(d)(1)(B).



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

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

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

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

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

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

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

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

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

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<sup>33</sup> Code §965.

<sup>34</sup> Code §965(e).

<sup>35</sup> Code §965(c).

<sup>36</sup> Code §965(g).

<sup>37</sup> Code §965(h).

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

<sup>39</sup> Code §951A.



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

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

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

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

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

### Removal of Qualified Business Asset Income

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

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

### Netting of Tested Income

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

### Foreign Tax Credit Computations

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

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<sup>40</sup> Code §951A(c)(2)(A)(i).

<sup>41</sup> Code §951A(b)(1).

<sup>42</sup> Code §951(b)(2)(A).

<sup>43</sup> Code §951(b)(2)(B).

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

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

The foreign income taxes attributable to G.I.L.T.I. are placed in a separate foreign tax credit limitation basket. The separate basket ring-fences the income and creditable taxes so that the U.S. tax on G.I.L.T.I. cannot be offset by excessive taxes on income in other baskets. The amount of foreign taxes creditable to G.I.L.T.I. is then multiplied by an inclusion percentage (discussed below) and reduced by 20% so that only 80% of available foreign tax credits attributable to G.I.L.T.I. are ultimately creditable.<sup>46</sup> This reduction has no effect on the gross-up under Code §78.

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

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

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<sup>44</sup> Code §960(d).

<sup>45</sup> Code §78.

<sup>46</sup> Code §960(d)(1).

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

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

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

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

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

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

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

<sup>47</sup> Code §250.

<sup>48</sup> Code §962.

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

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

<sup>51</sup> Code §250.

*"At the same time the T.C.J.A. accelerated tax under the G.I.L.T.I. regime for certain profits derived abroad from active business operations, it also provided a deduction for U.S. corporations operating in the U.S. to expand sales of products and services abroad."*



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

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

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

### **Base Erosion and Anti-Abuse Tax**

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

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<sup>52</sup> Code §250(a)(1)(A).

<sup>53</sup> Code §59A.

<sup>54</sup> Code §59A(d).

<sup>55</sup> Code §59A(g).

<sup>56</sup> Code §59A(e)(1).

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

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

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

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

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

- It is treated as owning shares in the U.S. corporation that represent at least 25% of the voting power or the value of all shares issued and outstanding.
- It is related to the corporation or to a 25% foreign owner of the corporation under constructive ownership rules similar to those discussed above that generally require more than 50% common ownership between two persons.
- It is treated as related to the taxpayer under the arm's length transfer pricing principles of U.S. tax law. This means that one party controls the other or they are both under common control, no matter how exercised.

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

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<sup>57</sup> Code §59A(c).

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

<sup>59</sup> Code §59A(d)(5).

### Limitations Placed on Business Interest Expense Deductions

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

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

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

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

### Other Revisions Affecting Cross-Border Groups

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

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

<sup>60</sup> Code §163(j).

<sup>61</sup> Code §163(j)(1)(C).

<sup>62</sup> Code §163(j)(7)(A).

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

<sup>64</sup> Code §482.

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



***“New I.R.S. regulations were adopted at the end of 2021 that are designed to limit the ability of U.S. taxpayers to offset U.S. tax by a credit for digital services taxes and other taxes that are imposed under foreign law. . .”***

### **Biden Tax Proposals**

In late Spring 2021, the Biden Administration announced its tax policies to pay for a spending program on domestic infrastructure and other items. As of June 30, 2021, there is much speculation on which of the specific provisions will make it into a final bill that can be approved by both the Senate and the House of Representatives and signed by the President.

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

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

### **U.S. Foreign Tax Credit Regulations**

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

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

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

Under the realization test, the tax must be imposed at the time when income is realized.<sup>66</sup> Under the gross receipts test, the tax must be imposed on gross receipts or the equivalent.<sup>67</sup> Under the net income test, the tax must be imposed on net income

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

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

after allowing for the recovery of expenses through immediate deductions against income or amortization of the total expenditure over time.<sup>68</sup>

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

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

## PATH FORWARD

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

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

The goal is to determine whether a particular European country provides tax treatment – alone or in conjunction with a second jurisdiction – that makes the formation of a holding company attractive to a U.S.-based group of companies. It must be staffed with competent persons having authority to make decisions and must avoid being a conduit to the U.S. parent. For many U.S. planners advising corporate

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

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

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

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

groups, this represents a major change of thinking, as the group's substance is frequently attributed to all group members — even those having no employees. In today's world, tax benefits must be seen as non-abusive and business plans must be generated by operational personnel rather than tax advisers. A structure that is recommended based solely on the arithmetic rate of tax — net income multiplied by a low corporation tax rate — will likely face unpleasant surprises on both sides of the Atlantic.



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

**Author**  
Eric Fort  
Arendt & Medernach  
Luxembourg

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## BACKGROUND

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

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

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

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

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

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

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

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

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

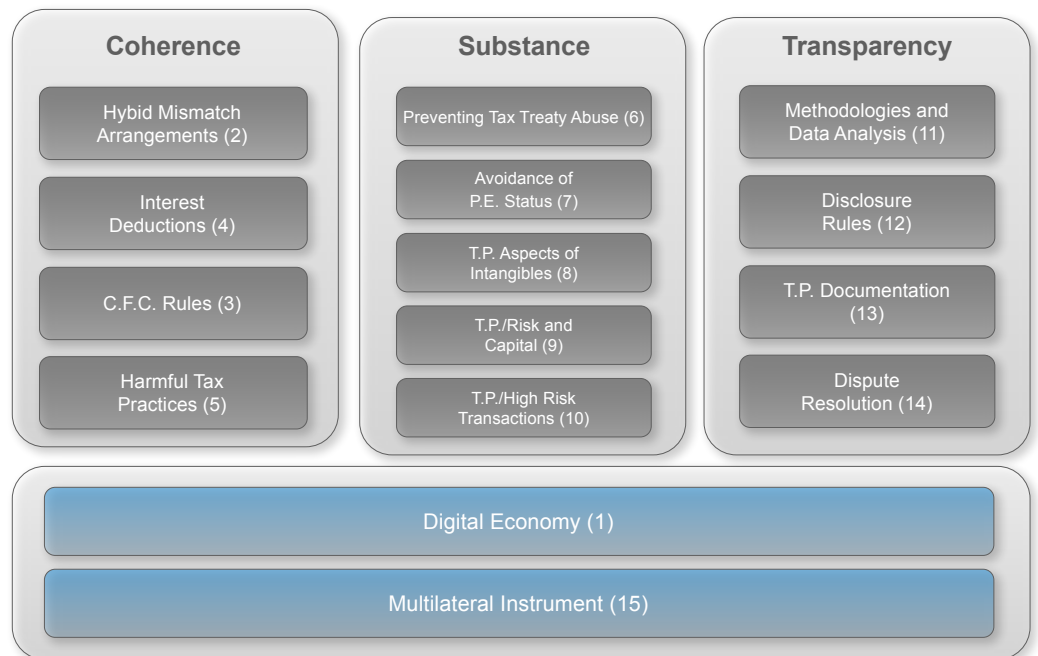
<sup>4</sup> O.E.C.D. (2013), *Addressing Base Erosion and Profit Shifting*, O.E.C.D. Publishing.

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

The actions are organized around three main pillars:

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

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



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

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

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

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



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

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

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

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

## 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

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

*“Even though the Final Recommendations have no binding legal authority, they reflect a global consensus as to best practices, and for that reason, they may be relied upon by tax authorities when challenging certain transactions or arrangements as abusive.”*

by certain operators. Cynics might say that the change is one in which smaller economies that thrived on arrangements to reduce tax in other countries will be required to reshape their economies to focus on more productive endeavors.

In calling for an internationally coordinated response, the B.E.P.S. Project requires support from each state at the domestic level. Each state retains its fiscal sovereignty and is free to apply the measures proposed by the O.E.C.D. on different terms, as long as it does not go against its international legal commitments. Thus, an adjustment period may be required in order to renegotiate tax treaties or to amend domestic law. At the same time, the O.E.C.D. created a mandate through Action Item 15 that called for an international conference to develop a multilateral instrument to amend the network of existing bilateral tax treaties in order to implement the B.E.P.S. Project's treaty measures all at once (the “M.L.I.”). On November 24 and 25, 2016, negotiations regarding the M.L.I. among over 100 jurisdictions were concluded and a signing ceremony was held on June 7, 2017 in Paris. The M.L.I. now covers over 1,700 tax treaties worldwide.

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

## EFFECTS ON HOLDING COMPANY STRUCTURES

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

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

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

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

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

On May 29, 2019, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. approved the *Programme of Work to Develop a Consensus Solution to the Tax Challenges*

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

*Arising from the Digitalisation of the Economy*<sup>7</sup> (the “*Programme*”), which is intended to be a roadmap for resolving the tax challenges arising from the digitalization of the economy providing for a process in order to reach a new global agreement for taxing multinational enterprises. The *Programme* foresees two main pillars:

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

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

On October 1, 2021, 137 jurisdictions released a joint statement<sup>12</sup> establishing a framework for Pillar One and Pillar Two.

On December 1, 2021, the O.E.C.D. released model rules under Pillar Two<sup>13</sup> for establishing a global minimum tax. On March 14, 2022, the O.E.C.D. released detailed technical guidance on the Pillar Two model rules, including commentary<sup>14</sup> on the global anti-base erosion model rules with illustrative examples,<sup>15</sup> and sought public comments.

In the first two quarters of 2022, the O.E.C.D. sought and received public comments on several aspects of the draft rules for Amount A of Pillar One, including nexus and revenue sourcing, tax base determinations, scope, extractives exclusion, regulated financial services exclusion, and tax certainty.

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

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

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

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

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

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

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

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

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

## **Pillar One**

The different approaches discussed under pillar one have the following aspects in common:<sup>16</sup>

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

On October 9, 2019, the O.E.C.D. published a public consultation document<sup>17</sup> describing the “Unified Approach” under Pillar One and on October 14, 2020, the O.E.C.D. published the Pillar One Blueprint, according to which the key features for a common solution should be as follows:

- **Scope:** In addition to automated digital services, consumer-facing businesses should be within the scope of the provision. However, sectors not in scope include notably extractive industries; certain financial services; construction; sale and leasing of residential properties; and international air and shipping businesses. Additionally, the Pillar One Blueprint provides that below two revenue-based thresholds (*i.e.*, a “global revenue” threshold based on the annual consolidated group revenue<sup>18</sup> and a “*de minimis* foreign in-scope revenue” threshold), the rules do not apply.
- **New Nexus:** Nexus based on sales in excess of certain thresholds. In relation to consumer-facing businesses, a “plus factor” to indicate a significant and sustained engagement with the market (*e.g.*, a subsidiary or a “fixed place of business”) should be considered in order to achieve a Nexus. Nexus is not dependent on physical presence. The new nexus should be designed as a new self-standing provision.
- **Tax Base Determination:** The tax base is determined on the basis of the profits of a group (rather than on a separate entity basis).
- **New Profit Allocation Rule going beyond the Arm's Length Principle:** Irrespective of an in-country marketing or distribution presence in the form of a permanent establishment or separate subsidiary or sales made via unrelated distributors. A three-step formulaic approach should identify the quantum of Amount A to be allocated to a business's marketing jurisdictions by applying (i) a “profitability threshold,” (ii) a “reallocation percentage,” and (iii) an “allocation key.”

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<sup>16</sup> Public consultation document, Secretariat Proposal for a “Unified Approach” under Pillar One, 9 October 2019 – 12 November 2019, p. 4.

<sup>17</sup> Public consultation document, Secretariat Proposal for a “Unified Approach” under Pillar One, 9 October 2019 – 12 November 2019.

<sup>18</sup> For example, the €750 million revenue threshold used for country-by-country reporting requirements.

- **Elimination of Double Taxation:** A mechanism that reconciles the new taxing right and the existing profit allocation rules is necessary to prevent double taxation by identifying the jurisdiction that must relieve double taxation.
- **A Three-Tier Profit Allocation Mechanism:**
  - **Amount A:** The adoption of a new taxing right for the market jurisdiction, giving it a share of a *deemed residual profit* by using a formulaic approach.  
  
The deemed residual profit would be the profit that remains after allocating what would be regarded as a *deemed routine profit* on activities to the countries where the activities are performed.<sup>19</sup>
  - **Amount B:** A fixed remuneration for baseline marketing and distribution functions that take place in the market jurisdiction.  
  
Activities in market jurisdictions, and in particular distribution functions, remain taxable according to existing rules regarding transfer pricing under the arm's length principle and permanent establishment allocations of profit. However fixed remuneration should be used reflecting an assumed baseline activity. A precise definition of activities qualifying for the fixed return is yet to be determined.
  - **Amount C:** Given the double taxation risks inherent in Amount A, it is intended to determine and implement a legally binding and effective dispute prevention and resolution method which would operate on a multilateral basis.

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

- Companies included in the scope of Pillar One are multinational enterprises ("M.N.E.'s") with global turnover above €20 billion and profitability above 10%. The turnover threshold will be reduced to €10 billion, contingent upon the successful implementation of tax certainty on Amount A. The relevant review would begin seven years after the agreement comes into force, and the review would have to be completed in no more than one year. Extractives and regulated financial services are excluded.
- A special purpose nexus rule will allocate Amount A to a market jurisdiction when the affected M.N.E. derives at least €1 million in revenue from that jurisdiction. For smaller jurisdictions with a G.D.P. under €40 billion, the nexus will be set at €250,000. The special purpose nexus rule will apply to determine whether a jurisdiction qualifies for the Amount A allocation.
- For affected M.N.E.'s, 25% of their residual profit, defined as profit in excess of 10% of revenue, will be allocated to market jurisdictions with nexus using a revenue-based allocation key. The profit or loss of the affected M.N.E. will be determined by its financial accounting income, with adjustments. Losses will be carried forward. Where the residual profits of an affected M.N.E. are



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

already taxed in a market jurisdiction, a marketing and distribution profits safe harbor rule will cap the residual profits allocated to the market jurisdiction through Amount A.

- Double taxation of profit allocated to market jurisdictions will be relieved using either the exemption or credit method. Tax liability will be drawn from those entities that earn residual profit. Affected M.N.E.'s will benefit from dispute prevention and resolution mechanisms.
- The work on Amount B and the application of the arm's length principle to in-country baseline marketing and distribution activities is expected to be completed by the end of 2022.
- A Multilateral Convention ("M.L.C.") will require all parties to remove all digital services taxes and commit to not introducing such measures in the future.

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

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

- **Draft rules for nexus and revenue sourcing under Amount A of Pillar One.**<sup>20</sup> These rules will be outlined in Title 4 of the model rules and incorporated into the M.L.C. and its explanatory statement. To determine whether a group satisfies the nexus test for Amount A in a jurisdiction, it will have to apply the revenue sourcing rules by identifying the market jurisdiction for a given type of revenue: finished goods, components, services, intangible property, real property, government grants, and non-customer revenues.
- **Draft rules for tax base determinations under Amount A of Pillar One.**<sup>21</sup> These rules will be outlined in Title 5 and in Title 9 (definitions) of the model rules and will be incorporated into the M.L.C. and explanatory statement. The model rules on tax base are designed to calculate the profit (or loss) of a group for the purposes of determining Amount A, based on the consolidated group financial accounts. The starting point will be the consolidated profit and loss statement, but certain book-to-tax adjustments, adjustments with respect to profit (or loss) restatements in relation to prior periods, and loss carry forward rules will apply.
- **Draft rules for scope under Amount A of Pillar One.**<sup>22</sup> These rules will be outlined in Title 2 and in Title 9 (definitions) of the model rules and will be incorporated into the M.L.C. and explanatory statement. The model rules on scope determine when a group will be included in the scope of Amount A and subject to the detailed provisions contained within the model rules.

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<sup>20</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Model Rules for Nexus and Revenue Sourcing*.

<sup>21</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Model Rules for Tax Base Determinations*.

<sup>22</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Draft Model Rules for Domestic Legislation on Scope*.



- **Extractives exclusion under Amount A of Pillar One.**<sup>23</sup> The rules will exclude the profits from extractive activities from the scope of Amount A. Extractive activities are defined by reference to two cumulative elements: a “product test” and an “activities test.”
- **Regulated financial services exclusion under Amount A of Pillar One.**<sup>24</sup> The rules will exclude the revenues and profits of the following categories of regulated financial institutions from the scope of Amount A:
  - Depository institutions
  - Mortgage institutions
  - Investment institutions
  - Insurance institutions
  - Asset managers
  - Mixed financial institutions
  - Regulated financial institution service entities

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

- **Tax certainty aspects of Amount A under Pillar One, including a tax certainty framework for Amount A**<sup>25</sup> **and a tax certainty process for issues related to Amount A.**<sup>26</sup> The framework guarantees certainty for affected groups over all aspects of the new rules, including the elimination of double taxation. The process for resolving issues set out a mandatory and binding mechanism that will be used to resolve transfer pricing and permanent establishment profit attribution disputes that competent authorities are unable to resolve through the mutual agreement procedure (“M.A.P.”) within two years of the presentation of the case to the competent authorities. The related rules will be incorporated into the model rules, the M.L.C., or other agreements and tools as needed.

## **Pillar Two**

On November 8, 2019 the O.E.C.D. published a public consultation document<sup>27</sup> on Pillar Two for the development of a coordinated set of rules to address ongoing risks from structures that allow multinational enterprises to shift profit to jurisdictions

<sup>23</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Extractives Exclusion*.

<sup>24</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Amount A: Regulated Financial Services Exclusion*.

<sup>25</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – A Tax Certainty Framework for Amount A*.

<sup>26</sup> O.E.C.D. (2022), *Public consultation document, Pillar One – Tax certainty for issues related to Amount A*.

<sup>27</sup> Public consultation document, Global Anti-Base Erosion Proposal (“GloBE”) - Pillar Two, November 8, 2019 –December 2, 2019, page 9, paragraph 30.

where they are subject to no or very low taxation. On October 14, 2020, the O.E.C.D. published the Pillar Two Blueprint. Pillar Two foresees a global minimum tax regime with an agreed effective minimum tax rate for internationally operating businesses within its scope. Changes to domestic law and tax treaties will be required.

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

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

#### *Income Inclusion Rule*

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

#### *Undertaxed Payments Rule*

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

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

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

#### *Subject to Tax Rule*

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

The relevant minimum tax rate is still to be determined.

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

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



## 2021 Framework

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

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

## Model Rules for Global Minimum Tax

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

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

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

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

- Chapter 1 addresses questions of scope.
- Chapters 2-5 contain the key operative rules. An M.N.E. can apply the rules in the following steps:
  - Calculate the effective tax rate in each jurisdiction where the M.N.E. operates. This requires a calculation of the income and of the tax on that income. The income (or loss) is calculated based on financial accounts, with certain adjustments to reflect common permanent differences, remove certain dividends and equity gains, or expenses disallowed for tax purposes. There is an exclusion for international shipping income. The tax attributable to that income includes income taxes. The rules also address temporary differences which arise when income or loss is recognized in a different year for financial accounting and tax.

***“On December 1, 2021, the O.E.C.D. released model rules for Pillar Two that would establish a global minimum tax.”***

- Calculate the top-up tax where there is low taxed income in a jurisdiction. The rate of tax owed is the difference between the 15% minimum rate and the E.T.R. in the jurisdiction. That top-up tax percentage is then applied to the GloBE income in the jurisdiction, after deducting a substance-based income exclusion (calculated as a percentage mark-up on tangible assets and payroll costs). If a jurisdiction has a domestic minimum tax that is consistent with the Pillar Two model rules, such domestic tax is credited against any Pillar Two minimum tax liability.
- Determine the liability for the top-up tax, *i.e.*, which entity within the M.N.E. will be liable for the top-up tax on the low-taxed income arising in a jurisdiction. Under the I.I.R., the minimum tax is paid at the level of the parent entity, in proportion to its ownership interests in those entities that have low-taxed income. Generally, the I.I.R. is applied at the top, at the level of the ultimate parent entity, and works its way down the ownership chain. The U.T.P.R. is the backstop rule which requires an adjustment (such as a denial of a deduction) that increases the tax at the level of the subsidiary and which is sufficient to result in the group entities paying their share of the top-up tax remaining after the I.I.R.
- Chapter 6 deals with mergers and acquisitions.
- Chapter 7 provides special rules that apply to certain tax neutrality and existing distribution tax regimes.
- Chapter 8 provides an internationally coordinated approach to administering the rules. This includes a standardized information return, mechanisms to avoid duplicative reporting, and the scope to release coordinated guidance on the application of the rules in practice. Chapter 8 also provides for the possibility of safe harbors. The final design and other aspects of administration, compliance, and coordination will be reflected in the implementation framework to be released in 2022.
- Chapter 9 provides for rules on transition.
- Chapter 10 contains definitions.

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

On March 14, 2022, the O.E.C.D. released detailed technical guidance on the Pillar Two model rules, including commentary on the global anti-base erosion model rules<sup>28</sup> and illustrative examples,<sup>29</sup> and sought public comments. The commentary provides guidance on the interpretation and application of the GloBE rules to ensure a consistent and common interpretation. It also includes examples which illustrate the application of the rules for certain fact patterns.

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<sup>28</sup> O.E.C.D. (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)*.

<sup>29</sup> O.E.C.D. (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) Examples*.

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

### Focus

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

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

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

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

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

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

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

Further, it should be noted that the O.E.C.D. issued additions to its Final Recommendations. The additions address hybrid mismatches<sup>30</sup> resulting from differences in the way payments between a permanent establishment and its head office are characterized under local tax law. The aim of these specific recommendations is to align the treatment of such structures with the treatment of classic hybrid mismatch arrangements.

### Illustrative Fact Patterns

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



<sup>30</sup> O.E.C.D. (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

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

Another example of hybrid mismatch can be found in arrangements with payments to reverse hybrid entities. Such entities are treated as tax transparent in one jurisdiction and as opaque in another. By way of illustration, a company that is resident in Country A owns all the issued and outstanding shares in a subsidiary resident in Country B. The subsidiary was formed under the laws of Country B. The subsidiary is tax transparent under Country B's laws but is regarded as a separate taxable entity under the laws of Country A. Company C, residing in Country C, borrows money from the subsidiary and makes an interest payment under the loan. The payment is deductible under Country C's tax law but is not included in income under the laws of either Country A or B. Each of those countries treats the income as being derived by a resident of the other jurisdiction.<sup>31</sup>

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

### **Recommended Action**

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

With respect to the domestic rules, the report recommends a denial of deductions in the country of the payer of the interest as the primary rule, and if the primary rule is not adopted in the relevant country, the imposition of tax in the country of the recipient as a secondary rule. In practice, when two jurisdictions are involved in a hybrid mismatch arrangement, the primary rule should determine which of the two 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.

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<sup>31</sup> O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

As to treaty language, the report sets out a range of recommendations for changes to the O.E.C.D. Model Tax Convention to ensure that hybrid instruments and entities, as well as dual resident entities, are not used unduly to obtain the benefits of treaties. The latest edition of the O.E.C.D. Model Tax Convention, of November 2017, reflects the additional hybrid mismatches recommendations under Action Item 2.

## **B.E.P.S. ACTION 3: DRAFTING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES<sup>32</sup>**

### **Focus**

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

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

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

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

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

### **Recommended Actions**

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

Firstly, the O.E.C.D. provides recommendations for developing rules that define what should be deemed a C.F.C. In order to define a C.F.C., the national legislator should (i) consider whether or not a foreign entity could be considered a C.F.C. by

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<sup>32</sup> O.E.C.D. (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.



determining what type of entities should fall within the scope of the national C.F.C. rules (*i.e.*, corporate entities, transparent entities, and permanent establishments) and (ii) determine whether the parent company located in the legislator's country has sufficient influence or control over the foreign entity by establishing legal and economic controlling tests, or if appropriate, the adoption of a *de facto* test or a more substantial anti-avoidance approach if considered necessary.

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

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

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

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

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

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

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

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

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

### **Focus**

Action Item 4 focuses on the need to address B.E.P.S. using deductible payments, such as interest, that can give rise to double nontaxation in inbound and outbound investment scenarios.<sup>33</sup>

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

- 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 no taxation of income
- A disproportionate level of third-party debt incurred by companies located in high-tax jurisdictions compared to the group overall debt

### **Recommended Action**

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

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

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

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

<sup>33</sup>

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

*“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.”*

Other suggestions are also proposed in Action Item 4 to tackle the adverse effects of a rigid application of the benchmark ratio approach, such as potential volatility in earnings that impact the ability to deduct interest expense in a particular period. Where that occurs, several safe harbors may apply, such as determining the group ratio rule on an equity-to-total assets ratio (“Equity Escape Rule”), or by using an average E.B.I.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*,<sup>34</sup> show that the topic has been discussed for many years among the different stakeholders. Action Item 5 proposes to reorganize the existing material gathered by the Forum on Harmful Tax Practices (the “Forum”) with regard to aggressive benefits granted to cross-border transactions by various countries in their respective domestic tax laws.

### **Illustrative Fact Patterns**

A typical argument and organization used by an M.N.E. when investing in intellectual property (“I.P.”) through a jurisdiction offering an attractive I.P. regime can be described as follows:

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

To address the situation, the M.N.E. interposes a company (“I.P. Co”) located in a jurisdiction that has laws providing a more favorable I.P. regime (“the other jurisdiction”). The I.P. rights are held by I.P. Co, and it receives royalties from other group members for the use of the I.P. These royalties are fully deductible by group members utilizing the I.P. but are fully or partially exempt when I.P. Co computes its tax under the laws of the other jurisdiction. The group uses the accumulated funds

<sup>34</sup>

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



within I.P. Co through intercompany loans that give rise to interest expense that is fully deductible by group members without being subject to withholding tax.

### **Recommended Action**

In October 2015, a final report on Action Item 5 was published.<sup>35</sup> In broad terms, Action Item 5 is aimed at tackling any corporate arrangements benefiting from disproportionate tax advantages in a given jurisdiction. It requires that corporate substance and activity should be in line with taxation and that tax transparency should be enhanced through the exchange of rulings related to low tax schemes.

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

As mentioned in the report, the nexus approach is the approach selected to impose a substantial activity requirement for preferential I.P. regimes. The nexus approach enables a taxpayer to benefit from an I.P. regime if it has itself performed the research and development that gives rise to the I.P. income. The nexus approach recommends that M.N.E.'s adjust their operational substance activity so that the tax benefit from the regime is closely tied to the economic reality of operations. In other words, income derived from eligible I.P. rights should derive benefits of a favorable tax treatment only in proportion to the research and development expenditures incurred by the taxpayer in relation to the I.P. rights, when compared to global expenditures related to the I.P. rights.

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

In the above example, the direct consequence of Action Item 5 will be that I.P. Co will be taxed at full corporate rates in the other jurisdiction on its royalty and license fee income after completion of the five-year grandfathering period, unless it fully staffs the company with personnel performing research and development activities. The other jurisdiction may provide tax and other incentives that are not considered 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.

<sup>35</sup>

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

The scope of the automatic exchange of ruling procedure covers six categories of rulings, viz., (i) rulings relating to preferential regimes, (ii) unilateral advance pricing rulings or other cross-border unilateral rulings in respect of transfer pricing, (iii) cross-border rulings providing for a downward adjustment of taxable profits, (iv) permanent establishment rulings, (v) related-party conduit rulings, and (vi) any other type of ruling which could give rise to B.E.P.S. concerns.<sup>36</sup>

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

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

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

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

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

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



<sup>36</sup>

*Id.*, p. 46.

On February 1, 2017, the O.E.C.D. released the *Terms of Reference and Methodology for Peer Reviews*<sup>37</sup> addressing the exchange of information on tax rulings. The peer review and the monitoring process will be conducted by the Forum to ensure the effective implementation of the agreed-upon standards.

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

In January 2019, the O.E.C.D. released the report “Harmful Tax Practices – 2018 Progress Report on Preferential Regimes,”<sup>38</sup> which includes the results of a review of preferential tax regimes since the start of the B.E.P.S. Project. This review was undertaken by the Forum on Harmful Tax Practices (“F.H.T.P.”) in accordance with the B.E.P.S. Action 5 minimum standards. In total, 255 preferential tax regimes were reviewed to ensure compliance with the nexus approach. More than half of these have been amended or abolished. The others were either already compliant with the Action 5 standard or in the process of being reviewed or reformed. As part of ongoing work to revise the existing F.H.T.P. criteria, a new standard, which imposes substantial activities requirements on low or no-tax jurisdictions, was adopted in 2018. In October 2019, the Inclusive Framework released guidance on the framework for the spontaneous exchange of information collected by low or no-tax jurisdictions.

On December 14, 2021, the O.E.C.D. released the 2020 peer review assessments of 131 jurisdictions regarding the spontaneous exchange of information on tax rulings. Twenty-two thousand tax rulings were identified and 41,000 exchanges between jurisdictions took place. Ninety-five jurisdictions were found to be in line with the B.E.P.S. Action 5 minimum standards, with the remaining 36 jurisdictions receiving one or more recommendations to improve their legal or operational framework for identifying and exchanging tax rulings. This is the first review that took place under the renewed peer review process issued on February 22, 2021.

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

### **Focus**

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

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

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<sup>37</sup> O.E.C.D. (2017), *B.E.P.S. Action 5 on Harmful Tax Practices – Terms of Reference and Methodology for the Conduct of the Peer Reviews of the Action 5 Transparency Framework*, O.E.C.D./IG-20 B.E.P.S. Project, O.E.C.D., Paris.

<sup>38</sup> O.E.C.D. (2019), *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, O.E.C.D./IG-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

The B.E.P.S. Action Plan has identified treaty abuse, and particularly treaty shopping, as one of the most important sources of base erosion and profit shifting. The Final Recommendations on Action Item 6<sup>39</sup> make a distinction between two types of treaty abuse:

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

### **Recommended Action**

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

- The inclusion in the title and preamble of tax treaties of a clear statement that the contracting states, when entering into a treaty, intend to avoid creating opportunities for nontaxation or reduced taxation.
- The inclusion in tax treaties of a specific anti-abuse rule based on the limitation on benefits (“L.O.B.”) provisions, as are already provided in treaties concluded by the United States and a few other countries.
- The addition to tax treaties of a more general anti-abuse rule (“G.A.A.R”) based on the principal purpose test (“P.P.T.”) to address other forms of treaty abuse.<sup>40</sup>

The L.O.B. clause provides a relatively objective basis for establishing a nexus between treaty benefits and entities having a relationship with the resident country. However, some commentators pointed out that non-collective investment vehicle (“non-C.I.V.”) funds<sup>41</sup> would not qualify under the L.O.B. rules, as they do not meet any of the proposed requirements.<sup>42</sup> Regarding their particular activity, discussions are taking place to determine whether these non-C.I.V. funds should qualify *per se* under the L.O.B. provisions or whether a genuine diversity-of-ownership test should apply under which each investor must meet an L.O.B. test separately.<sup>43</sup>

Since the L.O.B. clause might not catch all “conduit arrangements,” a G.A.A.R provision should be included in future tax treaties to deny benefits “if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that

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<sup>39</sup> O.E.C.D. (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

<sup>40</sup> *Id.*

<sup>41</sup> The term “C.I.V.” appears to be limited to funds that are widely held, hold a diversified portfolio of securities, and are subject to investor protection regulation in the country in which they are established. In this context, non-C.I.V. funds should refer, *inter alia*, to alternative funds, pension funds, and sovereign wealth funds.

<sup>42</sup> O.E.C.D. (2015), *Revised Discussion Draft, B.E.P.S. Action 6: Prevent Treaty Abuse*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

<sup>43</sup> O.E.C.D. (2016), *Public Discussion Draft, Treaty Entitlement of Non-C.I.V. Funds*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing.

benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.”<sup>44</sup>

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

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

[A] national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.<sup>45</sup>

Thus, the report recognizes that flexibility may be required in the adoption of the suggested rules in relation to domestic anti-abuse regimes, constitutional issues, policy choices, and E.U. laws.<sup>46</sup>

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

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.



<sup>44</sup> O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*.

<sup>45</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995.

<sup>46</sup> O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, p. 19, ¶¶21-22.

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

On February 14, 2019, the O.E.C.D. released peer review reports assessing the implementation of the Action 6 minimum standards, which reveal that as of June 30, 2018, a majority of the 116 B.E.P.S. Inclusive Framework members were in the process of modifying their treaty networks. The M.L.I., which implements the treaty related B.E.P.S. measures, appears to be the preferred tool. Additional peer reviews have been carried since 2019.

In April 2021, the O.E.C.D. released the Revised Peer Review Documents<sup>47</sup> including the Terms of Reference which set out the criteria for assessing the implementation of the minimum standard and the methodology which sets out the procedural mechanism by which the review will be conducted.

## **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.

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O.E.C.D. (2021), *BEPS Action 6 on Preventing the Granting of Treaty benefits in Inappropriate Circumstances – Revised Peer Review Documents*, O.E.C.D./G-20 on B.E.P.S., Paris.

*“Contracting States may choose to implement one of the three optional methods for the elimination of double taxation.”*

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

### **Hybrid Mismatches**

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

### **Transparent Entities**

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

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

### **Dual Resident Entities**

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

### **Elimination of Double Taxation**

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

- Under Option A, provisions of a Covered Treaty that would otherwise exempt income derived or capital owned by a resident of a Contracting State from tax in the other Contracting State do not apply if the other Contracting State also applies the treaty to exempt such income or capital from tax or to limit the rate of taxation thereof. In the latter case, a tax credit should be granted by the state of residence.
- Under Option B, provisions of a Covered Treaty that exempt dividend income derived by a resident of a Contracting State from tax in the other Contracting

State do not apply if such income gives rise to a deduction for the payor resident in the other Contracting State. In this case, a tax credit should be granted for the income tax paid in the source state.

- Under Option C, each Contracting State exclusively uses the credit method to eliminate double taxation for its residents.

### Treaty Abuse

#### Minimum Standards

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

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

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

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

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

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

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

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



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

#### Dividend Transfer Restriction

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

#### Capital Gains Derived Indirectly from Real Estate

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

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

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

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

#### Saving Clause

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



### Avoidance of Permanent Establishment Status

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

#### Commissionaire Arrangements

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

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

This amendment is optional for the Contracting States.

#### Specific Activity Exemptions

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

This amendment is optional for the Contracting States.

#### Splitting-Up of Contracts

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

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

In June 2020, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. published a progress report covering July 2019 through May 2020.<sup>48</sup> According to this report, of the 94 jurisdictions that were party to the M.L.I. in June 2020

- 46 jurisdictions have opted for the changes to Article 5(5) and 5(6) of the O.E.C.D. Model Tax Convention, lowering the threshold for the creation of a dependent agent permanent establishment;

<sup>48</sup>

O.E.C.D. (2019), *O.E.C.D./G20 Inclusive Framework on BEPS: Progress report July 2018 – May 2019*.

- 55 jurisdictions have opted for the amended Article 5(4) of the O.E.C.D. Model Tax Convention, with the preparatory or auxiliary requirement;
- 54 jurisdictions have opted for the anti-fragmentation rule in Article 5(4.1) of the O.E.C.D. Model Tax Convention; and
- 34 jurisdictions have opted for the anti-contract splitting provision included in the Commentary on Article 5 of the O.E.C.D. Model Tax Convention.

### Dispute Resolution and Arbitration

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

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

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

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

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

### 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. 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 affect a Covered Treaty with respect to

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

As of June 27, 2022, 76 out of the 99 jurisdictions that are party to the M.L.I. have deposited instruments of ratification.

### **Conclusion**

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

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

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

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

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

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

***"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."***

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

- Hybrid mismatches (Action Item 2),
- C.F.C. rules (Action Item 3),
- Limitation on interest deductions (Action Item 4), and
- The G.A.A.R. (Action Item 6).

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

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

On December 22, 2021, the E.U. Commission issued a proposal for a Council Directive on ensuring a global minimum level of taxation for multinational groups in the E.U. (the “Pillar Two Proposal”), discussed above. The Pillar Two Proposal builds on the O.E.C.D. GloBE rules and expands their scope to domestic groups. It will have to be implemented and applied by E.U. Member States largely by January 1, 2023. As all Directives related to tax, adoption of the Directive will require unanimous approval by Member States. On June 17, 2022, Hungary announced it would not vote in favor of the Directive, for the moment vetoing its adoption.

# EUROPEAN TAX LAW

**Author**  
Matthias Scheifele  
Hengeler Mueller  
Munich

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

Even if a measure meets the foregoing criteria, to be considered State Aid within the meaning of Article 107 §1 T.F.E.U., it may not be unlawful if one of the exemptions provided in Article 107 §§2 or 3 T.F.E.U. applies. For example, State Aid may be compatible with the internal market if it has a social character and is granted to individual consumers, eliminates damages caused by natural disasters or exceptional occurrences,<sup>4</sup> or is specific in relation to the former division of the Federal Republic

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

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

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

<sup>4</sup> The Commission views the COVID-19 outbreak as an exceptional occurrence; Commission Press Release, IP/20/454 (March 12, 2020).

of Germany.<sup>5</sup> In addition, the following may also be considered to be compatible with the internal market:<sup>6</sup>

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

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

Pursuant to the Procedural Regulation, the Commission decides whether a proposed measure constituting State Aid is compatible with the internal market.<sup>13</sup> After notice but prior to the Commission’s authorization, proposed State Aid measures must not be put into effect.<sup>14</sup> If the Commission finds that existing State Aid is incompatible with the internal market, it must decide whether the Member State granting the State Aid should amend or abolish the measure within a period of time as

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

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*, §3(a).

<sup>8</sup> *Id.*, §3(b). In particular, this exemption was of importance in the context of the financial crises. See also *Blumenberg/Kring*, IFSt Nr. 473, 2011, p. 21(f). Also in the context of the COVID-19 outbreak, a State Aid Temporary Framework to support the economy is based on this exemption; Commission Press Release, IP/20/570 (April 3, 2020) and STATEMENT/20/479 (March 17, 2020).

<sup>9</sup> *Id.*, §3(c).

<sup>10</sup> *Id.*, §3(d).

<sup>11</sup> *Id.*, §3(e).

<sup>12</sup> Council Regulation 2015/1589/E.U. on the Application of Article 108 of the T.F.E.U. (codification), 2015 O.J. L 248/9.

<sup>13</sup> *Id.*, art. 9.

<sup>14</sup> *Id.*, art. 3.

determined by the Commission.<sup>15</sup> State Aid must be recovered from the beneficiary unless the recovery of the aid would be contrary to a general principle of E.U. law.<sup>16</sup>

### **Application of State Aid Rules to Direct Business Taxation**

The principle of incompatibility of State Aid with the internal market applies to aid “in any form whatsoever.”<sup>17</sup> As a consequence, national provisions regarding direct business taxation may be considered State Aid if the definitional criteria of the T.F.E.U. are met. In 1998, the Commission clarified these criteria with respect to national tax provisions in the Commission Notice on the application of State Aid rules to measures relating to direct business taxation.<sup>18</sup> This notice was replaced by the Commission Notice on the notion of State Aid in 2016, which is not limited to tax measures but applies to all types of State Aid.

### **Economic Benefit**

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

### **Benefit Through State Resources**

With respect to taxes, an economic benefit can be identified as having been provided by state resources if the tax measure results in a loss of tax revenue. A positive transfer of funds does not have to occur.<sup>21</sup> This applies even if the tax-related State Aid may have an indirect positive overall effect on budget revenue.<sup>22</sup> State support need not be provided only by legislation. It may be provided through the practices of tax authorities.<sup>23</sup>



<sup>15</sup> T.F.E.U., art. 108, §2.

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

<sup>17</sup> State Aid and Direct Business Taxation, ¶2.

<sup>18</sup> *Id.*, *et seq.*

<sup>19</sup> *Id.*, ¶9.

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

<sup>21</sup> *Id.*, ¶51

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

<sup>23</sup> State Aid and Direct Business Taxation, ¶10.



### Negative Impact on Trade and Competition

The distortion of competition and the effect on trade are two distinct criteria, which are often treated jointly in the assessment of State Aid. According to the Commission, a distortion of competition exists when the State grants a financial advantage to an undertaking in a liberalized sector where there is, or could be, competition.<sup>24</sup> Regarding the effect on trade, it is not relevant if the aid has an actual effect on trade between Member States but only whether the aid is liable to affect such trade.<sup>25</sup>

### Selectivity

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

A measure is selective if it favors certain undertakings or the production of certain goods.<sup>26</sup> Therefore, measures of purely general application, which do not favor certain undertakings, cannot be seen as selective. However, even interventions which, at first appearance, apply to undertakings in general may be selective to a certain extent.<sup>27</sup>

Regarding generally applicable measures which mitigate the charges that undertakings would normally have to bear, e.g., tax exemptions for undertakings fulfilling certain criteria, the selectivity is determined by a three-step-analysis. As a first step, the system of reference must be identified. Second, it should be determined whether a given measure constitutes a derogation from that system insofar as it differentiates between economic operators who, in light of the objectives intrinsic to the system, are in a comparable factual and legal situation. If a measure does constitute a derogation, it is *prima facie* selective. In a third step, it has to be determined, whether the derogation is justified by the nature or the general scheme of the (reference) system.<sup>28</sup>

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

With respect to the nature or the general scheme of an identified tax system, the Commission holds, that progressive tax rates are justified by the redistributive purposes of income taxes. Furthermore, the need to fight fraud or tax evasion or the

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<sup>24</sup> *Id.*, 187.

<sup>25</sup> *Id.*, 190.

<sup>26</sup> *Id.*, ¶117.

<sup>27</sup> *Id.*, ¶118.

<sup>28</sup> *Id.*, ¶128.

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

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

need to avoid double taxation are basis for a possible justification.<sup>31</sup> In any case, the Member States are required to provide the Commission with a justification for the deviations during the notification procedure or the examination of potentially unlawful State Aid.<sup>32</sup>

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

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

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

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

Apart from these exceptions and pursuant to Article 16 §1 of the Procedural Regulation, Member States must take all necessary measures to recover the unlawful State Aid from the beneficiary, including interest on the deferred payment.<sup>41</sup> The recovery must be executed immediately and is subject to the national law of the concerned Member State, provided that its national provisions allow the immediate and effective execution of the recovery.

According to case law decided by the E.C.J., national procedural law must be interpreted in a way that does not negatively affect the enforcement of E.U. law (known as the “Supremacy of Community Law”).<sup>42</sup> Therefore, national rules providing that an administrative decision cannot be appealed after the expiration of a limitation

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

<sup>31</sup> *Id.*, ¶139.

<sup>32</sup> *Id.*, ¶141.

<sup>33</sup> *Id.*, ¶156 et seq.

<sup>34</sup> *Id.*, ¶164 et seq.

<sup>35</sup> *Id.*, ¶169 et seq.

<sup>36</sup> *Id.*, ¶177 et seq.

<sup>37</sup> *Id.*, ¶181 et seq.

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

<sup>39</sup> *Id.*, §32, ¶24.

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

<sup>41</sup> *Id.*, art. 16, §2.

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

period<sup>43</sup> or that suspend the effect of the Commission's decision for recovery are not applicable and will not override the obligation to obtain a refund of unlawful State Aid.<sup>44</sup>

## **Illustrative Examples**

### **In General**

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

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

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

### **Appeals by Starbucks and Fiat**

In September 2019, the General Court (“E.G.C.”) annulled the European Commission's decision regarding Starbucks,<sup>50</sup> whereas it confirmed the decision with respect to Fiat.<sup>51</sup> In both cases, the arm's length principle was found to be an

<sup>43</sup> *Id.*, ¶38.

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

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

<sup>46</sup> Commission Decision No. 2017/1283/E.U. (*Apple*), 2016 O.J. L 187/1. See also *Ireland v. Commission*, Case T-778/16 (pending case); *Apple Sales International and Apple Operations Europe v. Commission*, Case T-892/16 (pending case).

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

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

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

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

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



appropriate State Aid standard for determining whether a selective advantage was given to a particular company. If the Commission can demonstrate that a ruling allowed a company to depart from an arm's length determination of income, the ruling constitutes unlawful State Aid. In comparison, if no such showing is made by the Commission, a finding of unlawful State Aid is not warranted.

Regarding the Starbucks matter, the E.G.C. found that the Commission did not prove a selective advantage was granted by the tax ruling. Even certain methodological deficiencies in the application of the arm's length principle would not, *per se*, indicate the existence of a selective advantage within the meaning of State Aid law. In contrast, the Fiat decision by the E.G.C. confirmed the Commission's assertion that Luxembourg granted selective tax advantages by way of tax rulings that confirmed transfer prices that did not comply with market terms. This case is pending before the European Court of Justice ("E.C.J.") as of June 30, 2021.<sup>52</sup>

### Appeal by Apple

In the case of Apple, the Commission argued that the transfer prices used were negotiated with Irish tax authorities rather than substantiated by reference to comparable market transactions, and therefore the ruling does not reflect the arm's length principle under appropriate guidance for transfer pricing.<sup>53</sup> The Commission contended that, by allowing an unsubstantiated transfer pricing plan, Ireland granted a selective benefit to Apple by lowering its total tax burden.<sup>54</sup> In this dispute over a record back tax payment of €13 billion for Apple in Ireland, the E.G.C. annulled the Commission's decision.<sup>55</sup> The court explained that the Commission failed to prove that Ireland granted the U.S. technology company a legally impermissible tax advantage.

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

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

Amazon,<sup>56</sup> McDonald's,<sup>57</sup> Nike,<sup>58</sup> and Engie<sup>59</sup> have come under scrutiny by the Commission for allegedly having benefitted from unlawful tax-related State Aid granted by Luxembourg (Amazon, McDonald's, and Engie) and the Netherlands (Nike).

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<sup>52</sup> *Luxembourg and Fiat Chrysler Finance Europe v. Commission*, C-885/19 P and C-898/19 P.

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

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

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

<sup>56</sup> *State Aid to Amazon*, 2015/C 044/02. See also *Luxembourg v. Commission*, Case T-816/17 (pending case); *Amazon EU and Amazon.com v. Commission*, Case T-318/18 (pending case).

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

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

<sup>59</sup> E.G.C., Judgment of May 12, 2021, T-516/18 and T-525/18.

Regarding Amazon, the Commission concluded that the benefit unlawfully granted was worth approximately €250 million. Regarding McDonald's, the investigations indicated that the tax ruling in Luxembourg did not provide the company with selective tax treatment. Regarding Nike, the Commission opened an in-depth investigation in 2019 into tax treatment by the Netherlands. The Commission found that royalty payments permitted in a tax ruling were excessive and for that reason constituted unlawful State Aid.

In the Amazon case, the E.G.C. ruled against the Commission. According to the Commission, Amazon artificially inflated the settlement of royalties between various European subsidiaries in order to escape tax payments, which was explicitly approved by the Luxembourg authorities. However, the court found that the Commission failed to prove that Amazon's tax arrangements in Luxembourg constituted unlawful preferential treatment of the group, a fundamental requirement when asserting unlawful State Aid.<sup>60</sup> In contrast, the court confirmed the existence of a tax advantage in the tax rulings granted by Luxembourg to companies in the Engie group. In the decision, the court stated that preferential tax treatment resulted from the failure to apply a national measure relating to abuse of law. In the Nike case, the E.G.C. stated the lawfulness of the Commission's decision to initiate the formal investigation procedure. Stressing the importance of examining the individual measure, the court considered whether the Commission's assumption of selectivity met the threshold requirements for the formal investigation procedure without, of course, going into detail regarding the selectivity criteria to be applied.<sup>61</sup>

### Belgian Profit Ruling Scheme

Another example is the in-depth investigations opened by the European Commission in February 2015 regarding the Belgian excess profit ruling scheme.<sup>62</sup> Pursuant to Belgium's national tax regulations, multinational companies were allowed to reduce their tax base for alleged "excess profit" on the basis of a binding tax ruling.

Under such tax rulings, the actual recorded profit of a multinational was compared with the hypothetical average profit that a stand-alone company in a comparable situation would have made. The alleged difference in profit was deemed to be excess profit by the Belgian tax authorities, and the multinational's tax base was reduced proportionately. In practice, the actual recorded profit of companies participating in this scheme was often reduced by more than 50%, and in some cases, up to 90%.<sup>63</sup>

The Commission stated that Belgium provided a select number of multinationals substantial tax advantages in violation of E.U. State Aid rules. It ruled that the scheme distorted competition on the merits by putting smaller competitors on an unequal footing.<sup>64</sup> The Commission's 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 unlawful scheme (around €700

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<sup>60</sup> E.G.C., Judgment of May 12, 2021, T-816/17 and T-318/18.

<sup>61</sup> E.G.C., Judgment of July 14, 2021, T-648/19.

<sup>62</sup> Commission Decision No. 2016/1699 (State Aid), 2016 O.J. L 260/61.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

**“The German authorities’ view was that the clause was merely a new technical feature of the German tax system, and for that reason, could escape qualification as State Aid.”**

million).<sup>65</sup> The E.C.J. annulled the Commission’s decision.<sup>66</sup> The E.C.J. affirmed the competence of the European Commission to examine tax rulings under State Aid law. However, the E.C.J. found that, in principle, a tax ruling does not constitute unlawful aid if the underlying decision was in the discretion of the national tax authority and such discretionary decision was not a purely technical process. According to the E.C.J., for unlawful State Aid to exist, the Commission must demonstrate that comparable rulings have been granted in a systematic fashion.

### German Restructuring Relief

In February 2016, the E.G.C. confirmed the European Commission’s decision<sup>67</sup> that the so-called restructuring relief clause under German corporate tax law that enabled an ailing company to offset its losses in a given year against profits in future years, despite changes in its shareholder structure, amounts to State Aid.<sup>68</sup>

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

The German authorities’ view was that the clause was merely a new technical feature of the German tax system, and for that reason, could escape qualification as State Aid. This argument convinced neither the Commission nor the E.G.C. However, in line with the opinion<sup>69</sup> of Advocate General Wahl, the E.C.J. ruled that the general right to carry forward losses is the relevant reference framework, so that the benefit was not selective. The Commission erred when it viewed forfeiture of loss carryforwards in case of a change of control as the framework.<sup>70</sup>

### German Real Estate Transfer Tax

In another decision by the E.C.J., a rule under the German real estate transfer tax law which provided benefits to intra-group transfers of real estate or shares in real

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

<sup>66</sup> *Kingdom Belgium and Magnetrol International v. Commission*, Joined Cases T-131/16 & T-263/16, [2019] ECLI:EU:T:2019:91.

<sup>67</sup> Commission Decision No. 2011/527/E.U. (*Sanierungsklausel*), 2011 O.J. L 235/26.

<sup>68</sup> *SinnLeffers v. Commission*, Case T-620/11, [2016] E.G.C. ECLI:EU:T:2016:59.

<sup>69</sup> Opinion of the Advocate General Wahl, *Dirk Andres (administrator of Heitkamp BauHolding GmbH), previously Heitkamp BauHolding GmbH v. Commission*, Case C-203/16 P, [2017] ECLI:EU:C:2017:1017.

<sup>70</sup> *Andres (faillite Heitkamp BauHolding) v. Commission*, Case C-203/16 P, [2018] ECLI:EU:C:2018:505; *Germany v. Commission*, Case C-208/16 P, [2018] ECLI:EU:C:2018:506; *Germany v. Commission*, Case C-209/16 P, [2018] ECLI:EU:C:2018:507; *Lowell Financial Services v. Commission*, Case C-219/16 P, [2018] ECLI:EU:C:2018:508; see also *Strüber/von Donat*, IFSt Nr.531, 2019, p 26(ff).

estate owning entities<sup>71</sup> (subject to certain strict requirements), was found not to constitute unlawful State Aid. The intra-group relief is justified by the nature and overall structure of the underlying tax system as it helps to avoid double taxation and thus excessive taxation since real estate transfer tax was triggered by the initial acquisition of the real estate by the relevant group company.

### World Duty Free Group and Spain

Another ruling of the E.C.J. relates to a Spanish provision under which goodwill could be deducted when a Spanish-resident corporation acquired a shareholding in a foreign company equal to at least 5%.<sup>72</sup> No tax deduction for goodwill was granted when acquiring a shareholding in a domestic company.

Even though the E.C.J. returned the matter to the E.G.C., the ruling gave clear instruction on how the E.C.J. defines selectivity. A measure is selective if it places one undertaking in a position that is more favorable than that of another undertaking, although both undertakings are in a comparable factual and legal situation.<sup>73</sup> There is no need to identify certain specific features that characterize a group of undertakings that are beneficiaries to the tax advantage.<sup>74</sup>

This decision faces some criticism. According to the E.C.J., it is sufficient, if the measure in question discriminates between companies in comparable situations. It is not necessary for the Commission to determine the advantage for certain undertakings. Commentators have pointed out that this view is not compatible with the wording of Article 107 §1 T.F.E.U.<sup>75</sup>

### German Exemption of Waiver Gains

The increasing relevance of the State Aid rules for individual Member State's tax legislation is further evidenced by Germany's decision to notify the Commission of a new statutory rule providing for an exemption of waiver gains from income tax and trade tax.<sup>76</sup> The Commission responded to the notice by way of an informal and unpublished comfort letter confirming that they do not see any conflict with the State Aid rules.

### Path Forward

The extensive application of the State Aid rules with regard to direct taxation leads to a conflict with the principle of the autonomy of Member States in the field of

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<sup>71</sup> *A-Brauerei*, Case C-374/17, [2018] ECLI:EU:C:2018:1024; see also *Strüber/von Donat*, IFSt Nr.531, 2019, p 34(ff).

<sup>72</sup> *Commission v. World Duty Free Group*, Joined Cases C-20/15 P & C-21/15 P [2016] E.C.R. I (delivered Dec. 21, 2016).

<sup>73</sup> *Id.*, ¶79.

<sup>74</sup> *Id.*, ¶78.

<sup>75</sup> *Strüber/von Donat*, IFSt Nr.531, 2019, p 24(f).

<sup>76</sup> Section 3a *Einkommensteuergesetz* – *EstG* [hereinafter the “Income Tax Act”] and Section 3a *Gewerbesteuerengesetz* – *GewStG* [hereinafter the “Trade Tax Act”].

*“Moreover, E.U. law in the area of State Aid does not prevent Member States from adopting progressive tax rates reflecting the capacity of wealthier taxpayers to pay tax at higher rates than others having lower incomes.”*

taxation, and has been met with increasing criticism.<sup>77</sup> The E.G.C. for the first time examined the legality of a State Aid scheme under Article 107(2)(b) T.F.E.U. in the context of the COVID-19 pandemic and affirmed that State Aid provided in order to enable a company to overcome a crisis is not unlawful.<sup>78</sup> The case involved France, which supported airlines with French operating licenses with a payment moratorium during the pandemic. Ryanair, the holder of an Irish license, saw this as discrimination and filed a lawsuit. The E.G.C. ruled that France's aid measures to support airlines was lawful. In the decision, the E.G.C. pointed to a Commission ruling that a payment moratorium was compatible with the internal market. The moratorium provided that the payment of the monthly civil aviation tax and the solidarity levy on airline tickets from March to December 2020 can be deferred until 2021. According to the Commission, this constituted aid to make good the damage caused by natural disasters or exceptional occurrences (Article 107(2)(b) T.F.E.U.). The E.G.C. agreed with the Commission's view. This was the first time the E.G.C. examined the legality of a State Aid scheme under Article 107(2)(b) T.F.E.U. in the context of the COVID-19 pandemic.

The E.C.J. ruled that, with the exception of areas of tax law that have been harmonized, the determination of the basic characteristics of a tax provision under the law of a Member State is left to the discretion of that Member State, provided that the exercise of discretion is in accordance with E.U. law.<sup>79</sup> Moreover, E.U. law in the area of State Aid does not prevent Member States from adopting progressive tax rates reflecting the capacity of wealthier taxpayers to pay tax at higher rates than others having lower incomes. Similarly, Member States are not prohibited from using progressive taxation in the context of corporate taxes and taxes on persons with legal identity.

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

On March 3, 2021, the E.C.J. ruled with regard to Article 107(1) of the T.F.E.U. that, in accordance with settled case law, levies do not fall within the scope of the provisions of the T.F.E.U. on State Aid unless they constitute the method of financing an aid measure, and as a result, form an integral part of that measure.<sup>80</sup> In the facts of the case presented to the E.C.J., there was no indication that the revenue from the levy of the I.V.P.E.E., a direct tax on the value of the production of electric energy supplied to the Spanish electricity system, constituted a financing method amounting to unlawful State Aid. Consequently, the I.V.P.E.E. did not fall within the scope of the provisions of the T.F.E.U. on State Aid.

<sup>77</sup> Opinion of Advocate General Saugmandsgaard ØE, delivered on 19 September 2018, Case C-374/17, ECLI:EU:C:2018:741; *Strüber/von Donat*, IFSt Nr.531, 2019, p 67(ff).

<sup>78</sup> E.G.C. Judgment of February 17, 2021, T-259/20.

<sup>79</sup> E.C.J., Judgment of March 16, 2021, C-562/19 P.

<sup>80</sup> E.C.J., Judgment of March 3, 2021, C-220/19.



In another decision, the E.C.J. found that a Spanish law that lowered the taxes for Spanish football clubs amounted to unlawful State Aid.<sup>81</sup> Spanish law has long allowed specific Spanish football clubs – F.C. Barcelona, Real Madrid, Athletic Bilbao, and Atlético Osasuna – to pay lower taxes than most of its competitors. The basis of the lower tax was their characterization as non-profit organizations. The Court confirmed the Commission's view that the tax advantages provided by the law constituted unlawful State Aid, irrespective of other tax issues that also played a role. Although an aid scheme must always be considered as a whole, it is not necessary to determine the exact advantage that the beneficiary ultimately derives in order to establish the existence of aid. The quantification of the amount of the unlawful State Aid is deferred until the time of a recovery action by the Member State. The decisive factor, according to the E.C.J., was that the aid scheme was applied to favor the four football clubs but not their competitors, all of whom operated as stock corporations. Consequently, the advantage violated Article 107(1) T.F.E.U.

Another Spanish tax regime that was found to constitute unlawful State Aid related to certain finance lease agreements concluded by shipyards.<sup>82</sup> The E.G.C. found that the use of the tax scheme at issue was granted by the tax administration based on vague criteria for which no framework apparently existed. Specifically, the tax administration could determine the date of commencement of depreciation on the basis of criteria that were defined in such a way as to give the tax administration a significant margin of discretion. As a result, companies that received rulings were in a better position than other taxpayers with comparable facts. Consequently, the conditions relating to the risk of distortion of competition and its effect on trade between Member States were met.

## TRANSPARENCY MEASURES

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

### **Current Measures**

Currently, Council Directive 2011/16/E.U. (the “Administrative Cooperation Directive”), as amended,<sup>83</sup> lays down the provisions for the cooperation of Member States in the exchange of information that may be relevant to the administration of domestic tax law. On June 2, 2020, the Council approved the conclusions on the Directive.<sup>84</sup> The conclusions stress that efforts to improve administrative cooperation to

<sup>81</sup> E.C.J., Judgment of March 4, 2021 - C-362/19 P.

<sup>82</sup> E.G.C., Judgment of September 23, 2020, T-515/13 RENV and T-719/13 RENV.

<sup>83</sup> Council Directive 2011/16/E.U. on Administrative Cooperation in the Field of Taxation, 2011 O.J. L 64/1 [hereinafter the “Administrative Cooperation Directive”], amended by Council Directive 2014/107/E.U., 2014 O.J. L 359/1; Council Directive 2015/2376/E.U., 2015 O.J. L 332/1; Council Directive 2016/881/E.U., 2016 O.J. L 146/8 and Council Directive 2016/2258/E.U., 2016 O.J. L 342/1.

<sup>84</sup> Council of the European Union, *Council conclusions on the future evolution of administrative cooperation in the field of taxation in the EU*, June 2, 2020, 8482/20.

fight tax fraud and tax evasion are particularly relevant in the context of the need for recovery from the crisis caused by the COVID-19 pandemic.<sup>85</sup> Furthermore, it notes that the Directive does not provide for a procedure relating to data protection in the event of a data breach and calls on the Commission to suggest appropriate substantive amendments to the Directive or other relevant E.U. legislation. Meanwhile, it is appropriate to continue work on rapidly finding an administrative solution with the objective of improving the security of data exchanged between the authorities involved in tax information exchange and acting as data controllers.<sup>86</sup> The Member States should also establish a common standard at E.U. level for the reporting and tax information exchange mechanisms of income (revenue) generated through digital platforms.<sup>87</sup>

Pursuant to this Directive, Member States are obligated to share information that is foreseeably relevant to the administration of all taxes (except for V.A.T. and customs duties, excise duties, and compulsory social contributions) of another Member State in five different situations.<sup>88</sup>

### Mandatory Automatic Exchange of Information

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

- employment,
- director's fees,
- life insurance,
- pensions, 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.<sup>89</sup>

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

<sup>85</sup> *Id.*, No. 5.

<sup>86</sup> *Id.*, No. 14.

<sup>87</sup> *Id.*, No. 8.

<sup>88</sup> Administrative Cooperation Directive, art. 2, §2.

<sup>89</sup> *Id.*, art. 8, §3(a), as amended by Council Directive 2014/107/E.U.



- 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 Commission for purposes of monitoring the correct implementation of the directive.

### *Spontaneous Exchange of Information*

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

- The Member State supposes that there may be losses of tax in another Member State.
- A tax exemption or reduction in one Member State might give rise to an increasing tax liability in another Member State.
- Business dealings between two persons are conducted in a way that might result in tax savings.
- The tax authority of a Member State supposes that tax savings may result from an artificial transfer of profits between groups of enterprises.
- Information forwarded to a Member State has enabled information to be obtained which might be relevant for taxation in the other Member State.<sup>90</sup>

### *Exchange of Information on Request*

Member States must exchange information on taxes that may be relevant to another Member State upon request of the other Member State.<sup>91</sup>

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<sup>90</sup> *Id.*, art. 9, §1.

<sup>91</sup> *Id.*, art. 5.

### Country-by-Country Reporting

The amendment of the Administrative Cooperation Directive by Council Directive 2016/881/E.U. of May 25, 2016<sup>92</sup> introduced rules requiring multinational companies to report certain tax-related information and the exchange of that information between Member States. Under the new rules, multinational groups of companies located in the E.U. or with operations in the E.U. having a total consolidated revenue equal to or greater than €750 million will be obligated to file a Country-by-Country (“C.b.C.”) Report. The competent national authority that receives the C.b.C. Report must communicate the report by automatic exchange to any other Member State in which one or more constituent entities of the multinational group are either resident for tax purposes or are subject to tax with respect to business carried out through a permanent establishment. The C.b.C. Report is filed in the Member State in which the ultimate parent entity of the group or any other reporting entity is a resident for tax purposes. The report must include the following information for every tax jurisdiction in which the group is active:

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

In general, C.b.C. Reports must be provided within 15 months of the last day of the fiscal year of the reporting multinational group. The rule is somewhat different for the first C.b.C. Reports. The first reports must relate to the reporting group’s fiscal year commencing on or after January 1, 2016, and must be submitted within 18 months of the last day of that fiscal year.<sup>93</sup>

Germany implemented the provisions relating to C.b.C. Reporting and the automatic exchange of cross-border tax rulings and advance pricing arrangements into law on December 20, 2016.<sup>94</sup>

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<sup>92</sup> Council of the European Union, *Council conclusions on the future evolution of administrative cooperation in the field of taxation in the EU*, June 2, 2020, 8482/20. The directive is the first element of a January 2016 package of Commission proposals to strengthen rules against corporate tax avoidance. The directive builds on the 2015 O.E.C.D. recommendations to address base erosion and profit shifting and will implement O.E.C.D. B.E.P.S. Action 13, on country-by-country reporting by multinationals.

<sup>93</sup> *Id.*, art. 1, ¶2.

<sup>94</sup> *Gesetz zur Umsetzung der Änderungen der E.U.-Amtshilferichtlinie und von weiteren Maßnahmen gegen Gewinnverkürzungen und -verlagerungen (B.E.P.S.-Umsetzungsgesetz)* v. 23.12.2016, BGBl. I 2016, p. 3000 [“Law for the Implementation of the Amendments to the Administrative Cooperation Directive and of Further Measures Against Base Erosion and Profit Shifting”].

***“Other hallmarks exist even if the expectation of a tax advantage is not among the main benefits for entering the transaction.”***

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

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

A reportable cross-border tax arrangement must be identified by hallmarks, at least one of which must be present. Some of these hallmarks may only be taken into account where they fulfil the “main benefit test.” That test will be satisfied if it can be established that the expectation of a tax advantage is the main benefit or one of the main benefits, having regard to all relevant facts and circumstances, for entering into an arrangement.<sup>95</sup>

Hallmarks linked to the main benefit test include the following:

- Performance-based fees<sup>96</sup>
- Standardized structures (that are available to more than one relevant taxpayer without a need to be substantially customized for implementation)<sup>97</sup>
- Inappropriate legal steps to exploit losses<sup>98</sup>
- Conversion of income into non-taxed or low-taxed income<sup>99</sup>
- Circular transactions through intermediate companies without economic activity<sup>100</sup>
- Exploitation of territories with no corporate tax or a rate close to zero<sup>101</sup>
- Cross-border payments between two or more associated enterprises in tax jurisdictions with tax exemptions or preferential tax regimes<sup>102</sup>

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

<sup>95</sup> Administrative Cooperation Directive, Annex IV, Part I.

<sup>96</sup> *Id.*, Annex IV, Part II.A.2.

<sup>97</sup> *Id.*, Annex IV, Part II.A.3.

<sup>98</sup> *Id.*, Annex IV, Part II.B.1.

<sup>99</sup> *Id.*, Annex IV, Part II.B.2.

<sup>100</sup> *Id.*, Annex IV, Part II.B.3.

<sup>101</sup> *Id.*, Annex IV, Part II.C.1.(b).(i).

<sup>102</sup> *Id.*, Annex IV, Part II.C.1.(c) and (d).

- Payments between two or more associated enterprises where the recipient is not resident for tax purposes in any tax jurisdiction<sup>103</sup> or is resident in an E.U. blacklisted tax jurisdictions<sup>104</sup>
- Transfers of assets between two tax jurisdictions with substantially different valuations<sup>105</sup>
- Specific transfer pricing structures (e.g., arrangement which involves the use of safe-harbor-rules or arrangement involving the transfer of hard-to-value intangibles)<sup>106</sup>

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

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

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

Violations of the notification obligation are to be punished with a fine. The amount of the fine varies considerably between the E.U. Member States. Whereas, in some Member States, e.g. Latvia or France, the fine is less than €10,000, in other countries, the penalties are much higher. In the Netherlands, the fine can be up to €870,000 and in Poland even up to approximately €5 million. In Germany, the fine amounts up to €25,000.

### **Tax Transparency Package**

As part of its efforts to tackle corporation income tax avoidance and harmful tax competition in the E.U.,<sup>107</sup> and certainly as a reaction to the State Aid investigations resulting from the tax rulings to multinationals,<sup>108</sup> the Commission presented

<sup>103</sup> *Id.*, Annex IV, Part II.C.1.(a).

<sup>104</sup> *Id.*, Annex IV, Part II.C.1.(b).(ii).

<sup>105</sup> *Id.*, Annex IV, Part II.C.4.

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

<sup>107</sup> Commission Press Release, IP/15/4610 (Mar. 18, 2015).

<sup>108</sup> See **State Aid, Illustrative Examples**, above.



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 and (ii) the C.b.C. Reporting obligation, have already been implemented.<sup>109</sup>

### **Taxation Action Plans**

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 (the “Efficient Taxation Action Plan”).<sup>110</sup> Key actions include a plan to relaunch the Common Consolidated Corporate Tax Base (“C.C.C.T.B.”)<sup>111</sup> and to establish 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).<sup>112</sup> 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 noncooperative tax jurisdictions and an assessment of further options).<sup>113</sup> The Commission also promoted greater cooperation between Member States in the area of tax audits.<sup>114</sup> While the majority of the ideas within the Efficient Taxation Action Plan have not been thoroughly pursued since 2015, the Member States increasingly cooperate by way of so-called joint audits based on provisions of the European Directive on Mutual Administrative Assistance as amended in May 2021 (“D.A.C.7”). Furthermore, the Commission has set out an Action Plan for Fair and Simple Taxation on July 15, 2020 (the “Simple Taxation Action Plan”).<sup>115</sup> The Simple Taxation Action Plan consists of 25 initiatives which the E.U. Commission plans to implement between 2020 and 2024. In particular, the E.U. Commission intends to simplify tax procedural law, especially in terms of new technologies, and to improve tax compliance.

### **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

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<sup>109</sup> See **Transparency Measures – Current Measures**, above, and **Public Tax Transparency Rules for Multinationals**, below.

<sup>110</sup> 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).

<sup>111</sup> Commission Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 Final (Oct. 2016).

<sup>112</sup> Efficient Taxation Action Plan, p. 7.

<sup>113</sup> *Id.*, p. 12.

<sup>114</sup> *Id.*, p. 14.

<sup>115</sup> Commission Communication, COM (2020) 312 final (July 2020)

*“The proposal is still undergoing the parliamentary process, facing some criticism.”*

information will remain available for five years.<sup>116</sup> The proposal is still undergoing the parliamentary process, facing some criticism.<sup>117</sup>

### **Mandatory use of International Accounting Standards**

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

With respect to listed companies, Council Regulation 1606/2002/E.C., as amended,<sup>118</sup> grants the European Commission the authority to adopt the International Financial Reporting Standards, the International Accounting Standards, and the related Interpretations (“S.I.C./I.F.R.I.C.-Interpretations”) issued by the International Accounting Standards Board (“I.A.S.B.”).<sup>119</sup> 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”).<sup>120</sup> As a result, the international financial reporting standards are directly applicable in the domestic legislation of all Member States. If the I.A.S.B. issues new or amended standards or interpretations, the adoption of these new provisions follows a complex endorsement process.<sup>121</sup> Therefore, the I.A.S. Regulation is amended on a continuing basis.

Besides the use of international financial reporting standards, further reporting requirements for listed companies arise from the Transparency Directive<sup>122</sup> and the Prospectus Regulation.<sup>123</sup>

<sup>116</sup> 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.

<sup>117</sup> See the suggested amendments to the European Commission’s proposal in the Council’s statement of December 19, 2016, Interinstitutional File 2016/0107 (COD), document no. 15243/16.

<sup>118</sup> Council Regulation 1606/2002/E.C. on the Application of International Accounting Standards, 2002 O.J. L 243/1 [hereinafter “Application of I.A.S.”], as amended by Council Regulation 297/2008/E.C. on the Implementing Powers Conferred on the European Commission, 2008 O.J. L 97/62.

<sup>119</sup> Application of I.A.S., art. 2 and art. 3, §1.

<sup>120</sup> Commission Regulation 1126/2008/E.C. Adopting Certain International Accounting Standards, 2008 O.J. L 320/1.

<sup>121</sup> 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.

<sup>122</sup> Council Directive 2008/22/E.C. on the Harmonization of Transparency Requirements in Relation to Information About Issuers Whose Securities are Admitted to Trading on a Regulated Market, 2008 O.J. L 76/50 [hereinafter the “Transparency Directive”].

<sup>123</sup> Council Regulation 2017/1129/E.C. on the Prospectus to be Published when Securities are Offered to the Public or Admitted to Trading on a Regulated Market, and Repealing Directive 2003/71/EC with EEA Relevance, 2017 O.J. L 168/1264 [hereinafter the “Prospectus Regulation”].



- Pursuant to the Transparency Directive, issuers are required to inform the public market periodically about their financial statements and their management report.<sup>124</sup>
- Pursuant to the Transparency Directive, shareholders of listed companies are subject to reporting obligations if their voting rights exceed or fall below defined thresholds following an acquisition or a disposal of shares.<sup>125</sup>
- Pursuant to the Prospectus Regulation, which is directly applicable in the domestic legislation of all Member States, issuers of securities offered to the public are obliged to publish a comprehensive prospectus reporting information concerning the issuer and the securities to be offered.<sup>126</sup>

Companies in the legal form of limited liability companies or in the legal form of partnerships, whose partners have limited liability, fall under the scope of the Accounting Directive.<sup>127</sup> The Accounting Directive requires these entities to present their annual financial reports in compliance with the general principles set forth in the directive. These provisions broadly cover an entity's balance sheets, profit and loss accounts, notes on financial statements, and management reports. In addition, the Accounting Directive requires the publication and disclosure of the required information and the audit of financial statements. With respect to small- and medium-sized enterprises, the Member States may apply optional exemptions to the regulatory requirements of the Accounting Directive to avoid excessive demands for those undertakings. The laws and provisions necessary to comply with the Accounting Directive must be effective as of July 20, 2015.<sup>128</sup>

In addition, another directive requires large groups to report non-financial and diversity information. The affected companies will be obligated to publish information providing an understanding of the undertaking's development, performance, and position, the impact of its activity on environmental, social, and employee matters, and its respect for human rights and handling of anti-corruption and anti-bribery matters. The Member States were required to transfer these provisions into domestic law by December 6, 2016.<sup>129</sup>

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<sup>124</sup> Transparency Directive, Chapter II.

<sup>125</sup> *Id.*, Chapter III.

<sup>126</sup> Prospectus Regulation, art. 3.

<sup>127</sup> Council Directive 2013/34/E.U. on the Annual Financial Statements, Consolidated Financial Statements, and Related Reports of Certain Types of Undertakings, 2013 O.J. L 182/19 [hereinafter the "Accounting Directive"].

<sup>128</sup> *Id.*, art. 53, §1.

<sup>129</sup> See art. 4, §1 of Council Directive 2014/95/E.U. on the Disclosure of Non-Financial and Diversity Information by Certain Large Undertakings and Groups, 2014 O.J. L 330/1, which amends the Accounting Directive.

## ANTI-ABUSE AND TAX AVOIDANCE MEASURES

### General Anti-Abuse Doctrine Under E.U. Law

In two decisions,<sup>130</sup> the E.C.J. dealt with situations in which the abusive use of the Parent-Subsidiary Directive and the Interest and Royalties Directive was at issue.

The joined cases regarding the abusive use of the Interest and Royalties Directive<sup>131</sup> had essentially the same, or a similar, fact pattern. Private equity funds (“A”) based outside the E.U. held shares in an E.U.-based (Danish) group of companies through intermediary holding companies that were based in another E.U. Member State (Luxemburg or Sweden). The E.U.-based intermediary holding companies granted interest-bearing loans to the Danish companies. The Danish debtor companies requested an exemption from Danish withholding tax for interest payments made to the E.U. intermediary holding companies based on the place of residence of the intermediary holding companies in a Member State of the E.U. The exemption request was based on the Interest and Royalties Directive, whose benefits are available solely to E.U.-based companies. The Danish tax authorities denied the exemption on the grounds that the intermediate holding companies were not the beneficial owners of the interest income, but rather their non-E.U. owners, and that the insertion of the intermediate holding companies with little substance constituted an abusive practice designed to artificially create the conditions for obtaining a tax benefit under E.U. law.

This back-to-back lending arrangement was designed to achieve a reduction in withholding taxes under the Interest and Royalties Directive. The companies ultimately receiving the interest payments did not qualify for the elimination of withholding tax imposed by the E.U. Member State that was the place of residence of the ultimate borrower (Denmark). Hence, a two-legged arrangement was entered, in which the first leg of the back-to-back arrangement was the loan to the intermediary entities and the second leg was the loan to the Danish ultimate borrowers.

In its response to the various questions submitted by the Danish tax court in a request for a preliminary ruling on the interpretation of E.U. law, the E.C.J. held that the exemption from withholding tax on interest payments is restricted to the beneficial owner of the interest. The beneficial owner is the entity that actually benefits economically from the interest payment. To be the beneficial owner, the second lender in a two-legged transaction must have the power to freely determine the use to which the interest payment is put. The O.E.C.D. Commentaries to the Model Convention can be used to provide guidance on beneficial ownership for purposes of applying the beneficial ownership standard.

Moreover, applying general principles of E.U. law, the Interest and Royalties Directive cannot be relied upon as support for abusive and fraudulent ends. National courts and authorities are to refuse a taxpayer a benefit granted under E.U. law even if there are no domestic law or agreement-based provisions providing for such a refusal. Proof of an abusive practice requires a combination of (i) objective circumstances in which the purpose of those rules has not been achieved (despite

<sup>130</sup> *N Luxembourg 1 v. Skatteministeriet*, Joined Cases C-115, C-118, C-119 & C-299/16, [2019] ECLI:EU:C:2019:134; *Skatteministeriet v. T Danmark und Y Denmark Aps*, Joined Cases C-116/16 & C-117/16, [2019] ECLI:EU:C:2019:135.

<sup>131</sup> *Id.*



their formal observance) and (ii) a subjective element consisting in the intention to obtain an advantage from the E.U. rules by artificially creating a fact pattern that suggests the conditions are met for obtaining the benefit. The presence of certain indications may demonstrate that an abuse of law exists. These include (i) the existence of a conduit company that is without economic justification and (ii) the purely formal nature of the structure of the group of companies, the financial arrangements, and the loans.

As a final point, the E.C.J. looked at one of the structures in which A was a collective investment entity based in Luxembourg that benefitted from favorable tax treatment as a *Société d'Investissement en Capital à Risque* or S.I.C.A.R. A S.I.C.A.R. is a company with share capital and in principle is subject to Luxembourg corporate income tax and municipal business tax at ordinary rates. However, dividends and interest on risk capital derived by a S.I.C.A.R. is specifically exempt from tax in its hands. Similar tax rules apply to Reserved Alternative Investment Funds known as R.A.I.F.'s. The E.C.J. concluded that a S.I.C.A.R. cannot benefit from the Interest and Royalties Directive with regard to interest income that is exempt from tax in its hands.

The E.C.J. affirmed this principle in several cases regarding the Parent-Subsidiary Directive.<sup>132</sup> These cases concerned holding companies of E.U. Member States receiving dividends from their Danish subsidiaries and distributing them through other intermediary companies to investment funds and their shareholders. In these cases, the granting of benefits of the Parent-Subsidiary Directive to the holding companies was in issue. The E.C.J. ruled that the Parent-Subsidiary Directive cannot be applied in an improper or abusive fact pattern. A Member State is obligated to apply anti-abuse rules of its tax conventions and the O.E.C.D. Commentary to prevent abuse where national law contains no anti-abuse provision applicable to a particular transaction.

However, in a decision dealing with the German anti-treaty shopping legislation and directive rules regarding relief from dividend withholding taxes, the E.C.J.<sup>133</sup> ruled that a domestic anti-abuse provision<sup>134</sup> infringes upon the anti-abuse provision found in Article 2(1) of the E.U. Parent-Subsidiary Directive and the fundamental freedoms of E.U. law. The German law provided that an irrefutable presumption of abuse exists when certain facts are present. Consequently, no obligation is imposed on the tax authorities to provide even *prima facie* evidence of fraud or abuse. Consequently, it was not possible for the applicant to refute the allegation of abuse by factual evidence to the contrary. In the view of the E.C.J., in order to determine whether abuse is present, the structure must be examined on a case-by-case basis, with an overall assessment based on factors such as the organizational, economic, or other substantial features of the group of companies to which the parent company belongs and the structures and strategies of that group.

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<sup>132</sup> *Id.*

<sup>133</sup> *Deister Holding AG and Juhler Holding A/S*, Joined Cases C-504/16 & C-613/16, ECLI:EU:C:2017:1009.

<sup>134</sup> Section 50d(3) of the German Income Tax Act in the version of the Annual Tax Act 2007.

## **Legislative Measures**

In January 2016, the European Commission adopted an Anti-Tax Avoidance Package as part of its agenda for fair corporate taxation in Europe. The package contains concrete measures to “prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the E.U.”<sup>135</sup> One key element of this package is the Anti-Tax Avoidance Directive (“A.T.A.D. 1”). It introduces five legally binding anti-abuse measures that all Member States should apply against common forms of aggressive tax planning until December 31, 2018.<sup>136</sup> Its scope was expanded by A.T.A.D. 2 with regard to Hybrid Mismatches with Third Countries.

The Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments Member States of entities resident for tax purposes in a third country.<sup>137</sup>

### **General Interest Limitation Rule**

Under the general interest limitation rule, borrowing costs will be deducted to the extent that the taxpayer receives interest or other taxable revenues from financial assets. The deduction of any exceeding borrowing costs will be limited to an amount of 30% of the taxpayer’s earnings before interest, taxes, depreciation, and amortization or €3 million, whichever is higher.<sup>138</sup> 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

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<sup>135</sup> The key elements of the Anti-Tax Avoidance Package are (i) the Chapeau Communication, (ii) the Anti-Tax Avoidance Directive, (iii) the Administrative Cooperation Directive, (iv) the Recommendation on Tax Treaties, (v) the Communication on an External Strategy for Effective Taxation, and (vi) the Study on Aggressive Tax Planning; “[Anti-Tax Avoidance Package](#).” European Commission Taxation and Customs Union. January 2016, c.f., Commission Communication to the European Parliament and the Council on the Anti-Tax Avoidance Package, COM (2016) 23 Final (Jan. 2016).

<sup>136</sup> Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1 [A.T.A.D. I], amended by Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1 [hereinafter “A.T.A.D. II”].

<sup>137</sup> *Id.*, Article 1 §2.

<sup>138</sup> This provision on the interest limitation rule is similar to the current German interest limitation rule.

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 that falls into any of the following fact patterns:

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

A taxpayer may pay these exit taxes in installments over at least five years for transfers within the E.U. or the E.E.A.<sup>139</sup> Regarding a transfer involving an E.E.A. state, that state must have concluded an agreement on mutual assistance for the recovery of claims that complies with Council Directive 2010/24/E.U.<sup>140</sup>

### General Anti-Abuse Rule

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

### Controlled Foreign Corporation Rules

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

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

***“The provision on exit taxation obliges Member States to apply an exit tax when a taxpayer relocates its assets or tax residence.”***

<sup>139</sup> A.T.A.D., art. 5.

<sup>140</sup> Council Directive 2010/24/E.U. Concerning Mutual Assistance for the Recovery of Claims Relating to Taxes, Duties, and Other Measures, 2010 O.J. L 84/1.

have been charged under the applicable corporate tax system in the Member State of the taxpayer.

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

Undistributed income of a C.F.C. is included in a taxpayer's home country income. According to the E.U. Directive, Member States are allowed to adopt one of two approaches for computing the inclusion:

- The tainted undistributed income listed above is fully included in a shareholder's income, subject to an exception for the undistributed income of a C.F.C. that carries on a substantive economic activity supported by staff, equipment, assets, and premises. Members exclude this active business exception if the C.F.C. is not a resident of an E.U. Member State or an E.E.A. State.
- All undistributed income from non-genuine arrangements are included in a shareholder's income if obtaining a tax advantage is an essential purpose of the arrangement. Germany, for instance, has apparently opted for this slightly stricter approach.

Whether an arrangement is non-genuine is determined by reference to the staffing and performance of persons assigned to the C.F.C. or by the persons of the controlling company. The income to be included is based on the value of the functions performed by the staff of the controlling company. A *de minimis* rule applies so that companies with accounting profits that do not exceed 10% of the total income of the controlled company, provided that such amount does not exceed €80,000, are not covered by the C.F.C. rule.

### Hybrid Mismatches

A hybrid mismatch results from two jurisdictions giving different legal characterization to a business form – viz., whether a permanent establishment exists – or a

business transaction – viz., whether a payment is deductible interest or dividends paid on a participation. This may lead to a situation where

- a deduction of the same payment, expenses, or losses occurs both in the jurisdiction in which the payment has its source, the expenses are incurred, or the losses are suffered, and in another jurisdiction (double deduction);
- a deduction of a payment occurs in the jurisdiction in which the payment has its source without a corresponding inclusion of the same payment in another jurisdiction (deduction without inclusion); or
- no taxation occurs on income in its source jurisdiction without inclusion in another jurisdiction (no taxation without inclusion).

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

In respect of its territorial scope, A.T.A.D. 1 was limited to hybrid mismatches that arise in interaction between two Member States. Provisions concerning hybrid mismatches involving third countries were not included. In order to fix this insufficient territorial scope, the E.U. Council adopted A.T.A.D. 2,<sup>141</sup> which aims at neutralizing also tax effects from hybrid mismatches involving third countries, consistent with the recommendations outlined in the O.E.C.D. B.E.P.S. Report on Action 2.<sup>142</sup>

In addition to the broadening of the territorial scope, the amended provisions<sup>143</sup> now also address further types of hybrid mismatches which were not yet covered by the anti-tax avoidance measures in A.T.A.D. 1. The rules on hybrid mismatches are divided into three provisions as follows:

- **Hybrid Mismatches:**<sup>144</sup> Article 9 already existed under A.T.A.D. 1, the amended version now acts as a catch-all element tying on the broadly defined terms “hybrid mismatch” and “hybrid transfer.” In comparison to the original scope the provision additionally covers the following structures:
  - **Hybrid Permanent Establishment Mismatches:** Two jurisdictions differ on whether a business activity is being carried out through a permanent establishment.



<sup>141</sup> Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

<sup>142</sup> O.E.C.D. (2015), *Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2 2015 Final Report*, O.E.C.D./IG-20 Base Erosion and Profit Shifting Project, O.E.C.D., Paris.

<sup>143</sup> *Id.*, art. 9, 9a, 9b.

<sup>144</sup> *Id.*, art. 9.

- **Hybrid Transfers:** Two jurisdictions differ on whether the transferor or the transferee of a financial instrument has the ownership of the payments on the underlying asset.
- **Imported Mismatches:** The effect of a hybrid mismatch between parties in third countries is shifted into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralize hybrid mismatches.
- **Reverse Hybrid Mismatches:**<sup>145</sup> Reverse hybrid mismatch structures occur where an entity is incorporated or established in a Member State that qualifies the entity as transparent and a direct or indirect interest in 50% or more of the voting rights, capital interest or rights to a share of profit is held in aggregate by one or more associated nonresident entities located in a third country that regards the entity as non-transparent. Pursuant to Article 9a(1) the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income is not otherwise taxed under the laws of the Member State or any other jurisdiction. This provision shall not apply to a collective investment vehicle, *i.e.*, an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.<sup>146</sup>
- **Tax Residency Mismatches:**<sup>147</sup> The taxpayer is resident for tax purposes in two (or more) jurisdictions. A deduction for payment, expenses or losses from the tax base of this taxpayer is possible in both jurisdictions. Article 9b directs the Member State of the taxpayer to deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If both jurisdictions are Member States, the Member States where the taxpayer is not deemed to be a resident according to the D.T.C. between the two Member States concerned shall deny the deduction.

Member States are required to adopt the A.T.A.D. 2 into their domestic tax law by January 1, 2020 and, in respect of the reverse hybrid mismatch rules, by January 1, 2022.

### Proposed “Unshell” Directive

On December 22, 2021, the E.U. Commission published a proposal for a directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/E.U. (the “Unshell Directive”).<sup>148</sup> The key element of the proposal is a threefold substance test to assess whether an entity shall be deemed a shell company. The principles of this substance test are as follows:

- In the first step, an entity will fail substance requirements if more than 75% of its income consists of income from financial assets, intellectual or intangible

<sup>145</sup> *Id.*, art. 9a. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.

<sup>146</sup> *Id.*, art. 9a §2.

<sup>147</sup> *Id.*, art. 9b.

<sup>148</sup> E.U. Commission Communication COM (2021) 565 final (December 2021).



property, dividends and capital gains from shares, or other categories of income from specific outsourced activities.

- An entity will fail the second step of the test if at least 60% of its income is received through transactions involving more than one jurisdiction or passed on to entities that are not resident in the same jurisdiction as the entity under review.
- The third and final step will be failed if the entity has outsourced its administration of day-to-day operations and decision-making on significant functions within the last two tax years.

If the entity is deemed to be a shell company, it will need to declare a minimum level of substance in the Member State of its tax residence. Otherwise, the company will lose the protection of double taxation agreements between its Member State and other Member States of the E.U., as well as any tax relief based on E.U. Directives.

## CONCLUSION

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

*“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.”*

## LUXEMBOURG

### Author

Frank van Kuijk  
Loyens & Loeff  
Luxembourg

Over the last few decades, Luxembourg has been extremely popular as a holding and financing jurisdiction for both E.U. and non-E.U. investors, as well as an attractive location for collective investment funds and their managers. Its position as an important financial center, and the professional environment it offers, combined with 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.

Under Luxembourg law, a variety of legal forms and fund regimes are available and suitable for holding, financing, and investment activities.

A taxable Luxembourg holding company, which in French is often referred to as a “*société de participations financières*” or a “S.O.P.A.R.F.I.,” is an attractive vehicle to serve as a group holding company or investment platform. A S.O.P.A.R.F.I. is a normal commercial company that may carry out any activities falling within the scope of its corporate purpose clause. A S.O.P.A.R.F.I. may take the form of, *inter alia*, a *société anonyme* (“S.A.,” a public limited company), a *société à responsabilité limitée* (“S.à r.l.,” a limited liability company), or a *société en commandite par actions* (“S.C.A.,” a partnership limited by shares). As capital company, a S.O.P.A.R.F.I. is fully subject to Luxembourg income tax and net worth tax. Profit distributions by a S.O.P.A.R.F.I. are, in principle, subject to a 15% Luxembourg dividend withholding tax. As entity fully subject to Luxembourg income tax, a S.O.P.A.R.F.I. is generally entitled to the benefits of the tax treaties concluded between Luxembourg and other countries and the E.U. tax directives.

Another attractive investment vehicle is a private wealth management company - *société de gestion de patrimoine familial regime* (“S.P.F.”). In contrast to the S.O.P.A.R.F.I., an S.P.F. is fully exempt from Luxembourg corporate income and withholding taxes but is neither eligible for protection under the Luxembourg bilateral tax treaties nor covered by the E.U. tax directives.

Luxembourg law further provides for several collective investment vehicles. One regime applies to investments in risk-bearing capital (e.g., venture capital and private equity), namely the *société d’investissements en capital à risque* (“S.I.C.A.R.”). A second regime applies to reserved alternative investment funds (“R.A.I.F.”). It provides lighter establishment guidelines and more flexible corporate and operating regulations fitting the needs of alternative investment fund (“A.I.F.”) managers and investors. A third regime provides a legal and regulatory framework for securitization vehicles (“*sociétés de titrisation*”) coupled with a favorable tax regime. The S.I.C.A.R., the R.A.I.F., and the securitization vehicle will be discussed below. In addition, Luxembourg non-regulated funds are often set up under the form of a Luxembourg (special) limited partnerships or “*société en commandite (spéciale)*”; however, a discussion on that form of partnership is beyond the scope of this contribution.

The author acknowledges the contribution of his colleague Megane Lindecker, also of Loyens & Loeff, in the preparation of this section.

## 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 24.94% as of January 1, 2020. This rate includes the 17% national corporation income tax (“C.I.T.”), plus the 6.75% Luxembourg City municipal business tax (“M.B.T.”), and a 7% unemployment fund surcharge.

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 proceeds) 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 (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.”)<sup>1</sup> or a permanent establishment thereof, provided the hybrid loan provision and the general anti-abuse rule known as “the G.A.A.R.” do not apply (please see below), (ii) a fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D., or (iii) a non-Luxembourg capital company subject in its country of residence to a profit tax comparable to Luxembourg’s C.I.T. in terms of rate and taxable basis (“the Comparable Tax Test”). See **Subject to Tax**, below, for further details.
- 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).

Regarding the second condition described in item (b)(i) above, the Luxembourg participation exemption was amended in line with the revised P.S.D.<sup>2</sup> and includes a provision countering hybrid loan arrangements and implementing the G.A.A.R. The hybrid loan provision aims at preventing double non-taxation via the use of hybrid financing arrangements by limiting the exemption of payments received through such arrangements if such payment is deducted in another E.U. Member State. The G.A.A.R. requires E.U. Member States to refrain from granting the benefits of the

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<sup>1</sup> A company is covered by article 2 of the P.S.D. when it takes one of the forms listed in the Annex I to the P.S.D., is tax resident in a Member State, is not considered tax resident elsewhere, and is subject to tax without the possibility of an option to be exempt or actually being exempt.

<sup>2</sup> The P.S.D. was amended in 2014 and 2015 by Council Directive 2014/86/E.U. and Council Directive 2015/121, respectively. By law of December 18, 2015, and effective January 1, 2016, such amendments were implemented in the I.T.A.

*“The participation exemption applies on a per-shareholding basis.”*

P.S.D. to certain arrangements that are not “genuine.” For the arrangement to be non-genuine, one of its main purposes must be to obtain a tax advantage that would defeat the object or purpose of the P.S.D. Therefore, dividends received by a Luxembourg taxpayer from a subsidiary in the E.U. (including in principle Luxembourg subsidiaries) are not exempt if they are deductible by the E.U. subsidiary distributing the dividend. In addition, when the P.S.D.-based participation exemption is applied, the dividend arrangement must not violate the G.A.A.R. in order for the exemption to apply. The G.A.A.R. should not apply to distributions from a Luxembourg company to another Luxembourg company that is normally subject to tax.

The Luxembourg domestic participation exemption could be viewed as still being available notwithstanding the G.A.A.R. if the subsidiary meets the Comparable Tax Test referred to under item (b)(iii) above, and further detailed in **Subject to Tax** below, in the context of an income tax treaty, which should be the case for many E.U. Member State subsidiaries.

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

### **Capital Gains**

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

- The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax-transparent entity), or the participation has an acquisition cost of at least €6 million.
- The subsidiary is (i) an entity falling within the scope of Article 2 of the P.S.D. or a permanent establishment thereof, (ii) a fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D., or (iii) a non-Luxembourg capital company meeting the Comparable Tax Test.
- The S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, a minimum participation, as mentioned above, for an uninterrupted period of at least 12 months.

The capital gains exemption is not subject to the G.A.A.R. as implemented in Luxembourg law following the amendments to the P.S.D., as the latter only relates to dividends and not capital gains.

## **SUBJECT TO TAX**

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

Based on parliamentary history, the Comparable Tax Test requires that the nonresident subsidiary (i) be subject to a tax rate of at least half the Luxembourg C.I.T. rate (*i.e.*, at least 8.5% as of 2022) and (ii) be subject to tax on a basis that is determined in a manner comparable to the determination of the taxable basis in Luxembourg. However, the Comparable Tax Test is based on parliamentary history and is not set out in the law in detail. It is, amongst other issues, not fully clear whether the Comparable Tax Test should be applied on the basis of an effective rate or basis. Furthermore, no list of qualifying countries exists for this purpose. Thus, where comparability is subject to doubt, an advance tax agreement (“A.T.A.”) can be requested from the Luxembourg tax authorities (“L.T.A.”).

Beyond the domestic participation exemption, certain treaties concluded by Luxembourg contain a lower rate or a participation exemption for dividends, without a Comparable Tax Test being required. Therefore, by virtue of such treaties, dividends received from favorably taxed foreign companies, such as a Swiss finance company, should be exempt from tax at the S.O.P.A.R.F.I. level. In addition, the minimum ownership period requirement of a treaty is generally shorter than the period required under Luxembourg law (*e.g.*, the beginning of the accounting year versus 12 months). Application of these more favorable treaty provisions is subject to the Multilateral Instrument applying as discussed below in **Withholding Tax in a Foreign Subsidiary’s Country**.

## TAX-FREE REORGANIZATIONS

The Luxembourg I.T.A. provides for certain reorganizations that are viewed as tax-free in the hands of shareholders of certain capital companies (*i.e.*, application of a roll-over). Such favorable tax treatment applies to the following situations:<sup>3</sup>

- Transformations of a capital company into another capital company whereby securities of the transformed company are issued to the shareholder
- Mergers or demergers 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
- Certain share-for-share exchange transactions

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

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

During the five years following the year in which one of the foregoing transactions occurs, income derived from a participation (*i.e.*, dividends and capital gains) received

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<sup>3</sup> Such tax-free reorganizations used to include conversions of a loan whereby securities representing share capital of the debtor were issued to the creditor. Effective January 1, 2019, Article 22-*bis* of the I.T.A. was amended to no longer include such conversions.

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 a country where it is subject to tax, as discussed above in **Subject to Tax**).

## 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) met will not qualify for the participation exemption described above. However, dividend income derived from such interests may be eligible for a 50% exemption, provided that such dividends 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. The exemption applies to the net dividend income which corresponds to the dividend received minus costs related to the participation incurred in the same year.

## WITHHOLDING TAX IN A FOREIGN SUBSIDIARY'S COUNTRY

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

As of the date of this article, Luxembourg has 84 income tax treaties in force with the following jurisdictions:

Andorra	Germany	Malaysia	Slovakia
Armenia	Greece	Malta	Slovenia
Austria	Guernsey	Mauritius	South Africa
Azerbaijan	Hong Kong	Mexico	South Korea
Bahrain	Hungary	Moldova	Spain
Barbados	Iceland	Monaco	Sri Lanka
Belgium	India	Morocco	Sweden
Botswana	Indonesia	Netherlands	Switzerland
Brazil	Ireland	Norway	Taiwan
Brunei	Isle of Man	Panama	Tajikistan
Bulgaria	Israel	Poland	Thailand
Canada	Italy	Portugal	Trinidad & Tobago

China	Japan	Qatar	Tunisia
Croatia	Jersey	Romania	Turkey
Cyprus	Kazakhstan	Russia	Ukraine
Czech Republic	Kosovo	San Marino	U.A.E.
Denmark	Laos	Saudi Arabia	U.K.
Estonia	Latvia	Senegal	U.S.A.
Finland	Liechtenstein	Serbia	Uruguay
France	Lithuania	Seychelles	Uzbekistan
Georgia	Macedonia	Singapore	Vietnam

Additionally, Luxembourg is in the process of negotiating 15 new income tax treaties, five of which have already been signed.

Luxembourg signed the Multilateral Instrument on June 7, 2017. On February 14, 2019, Luxembourg parliament adopted the law ratifying the Multilateral Instrument, for which the O.E.C.D. was notified on April 9, 2019. Luxembourg covered nearly all of its treaties, except Cyprus, which already complies with the minimum standards and contains a principal purpose test (“P.P.T.”).

Apart from certain compulsory provisions tackling treaty abuse scenarios, such as an introduction of the P.P.T., Luxembourg accepted only a few optional rules proposed by the Multilateral Instrument. According to the Luxembourg parliamentary explanatory note to the Multilateral Instrument ratification law, Luxembourg decided to follow its traditional policy of prudence and opted in only to those provisions that are in line with its current treaty policy, as well as provisions introducing minimum standards that are mandatory. Hence, Luxembourg has sought to limit its scope and impact to the minimum standards required.

In particular, Luxembourg has chosen option A in relation to Article Item 5 (Application of Methods for the Elimination of Double Taxation) and the P.P.T. without applying the limitation on benefits clause in relation to Article Item 7 (Prevention of Treaty Abuse). Luxembourg will not apply Article Item 4 (Dual Resident Entities), Article Item 8 (Dividend Transfer Transactions), Article Item 9 (‘Real Estate Rich’ Company Clause), Article Item 10 (Anti-Abuse Rule for Permanent Establishments situated in Third Jurisdictions), Article Item 11 (Savings Clause), Article Item 12 (Artificial Avoidance of Permanent Establishment Status through Commissionaire Arrangements), Article Item 14 (Splitting Up of Contracts), or Article Item 15 (Definition of a Closely Related Persons).

The extent to which treaties will be amended as a result of the Multilateral Instrument depends on whether or not the other treaty partners signed the Multilateral Instrument. Based on the choices of its treaty partners, Luxembourg currently expects 62 of its income tax treaties to be affected by the Multilateral Instrument (these treaties will hereinafter be referred to as “Affected Treaties”), which include the following treaty partners: Austria, Canada, France, Germany, Italy, the Netherlands, Spain, and the U.K.

The entry into force of the Multilateral Instrument with respect to Luxembourg occurred on August 1, 2019. However, that does not mean that the Affected Treaties will be revised by the Multilateral Instrument as per that date. Rather, the Multilateral Instrument has a relatively complex mechanism to determine as of which date it will actually affect specific tax treaties, whereby a difference exists between the



effect on withholding taxes and the effect on other taxes. For Affected Treaties with treaty partners which have already notified the O.E.C.D. prior to October 1, 2019, of their ratification of the Multilateral Instrument, the Multilateral Instrument entered into effect (i) for withholding taxes on January 1, 2020 and (ii) for all other taxes for financial years starting on or after February 1, 2020 (*i.e.*, for calendar year taxpayers on January 1, 2021). In respect to Affected Treaties with treaty partners that have notified the O.E.C.D. after October 1, 2019, of their ratification of the Multilateral Instrument, the Multilateral Instrument entered into effect (i) for withholding taxes, on January 1, 2021 at the earliest and (ii) for all other taxes, it may be January 1, 2021, for calendar year taxpayers, or it may be a later year.

## 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 while the carry-forward of losses incurred as of January 1, 2017, is limited to 17 years after the losses occurred (*i.e.*, until December 31, 2039, for losses incurred during the 2022 fiscal year). Carryback of losses is not allowed.

It should be noted that deductions claimed in prior years in connection with reduced values of an exempt participation are recaptured in the event a gain is realized from a subsequent disposition of the entity. The capital gains exemption described in **Dividends** above, does not apply to the extent of the previously deducted expenses and value adjustments related to a participation. As a result, capital gains arising from a disposition of shares may be taxable in part and offset by available losses carried forward.

### Financial Costs

Financing expenses connected with an exempt participation are not tax deductible to the extent that they do not exceed exempt income arising from the participation in a given year. The exceeding part is further only deductible and can only 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) to the extent it does not fall within the scope of the interest deduction limitation rules described in **Interest Payment on Straight and Hybrid Debt**.

In principle, expenses are allocated on an historic direct-tracing basis. Where direct tracing is not possible, expenses are allocated on a *pro rata* basis that looks to the relative value of each participation.

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



Unrealized currency losses on the investment and on repayments of capital are deductible but may cause the recapture rules to apply in a subsequent period.

### **Liquidation Losses**

A loss realized upon liquidation of a participation is deductible.

## **WITHHOLDING TAX ON OUTBOUND DIVIDENDS AND CAPITAL GAINS**

### **Distributions on Shares**

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

- An entity falling within the scope of Article 2 of the P.S.D., or a permanent establishment thereof.
- A fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D.
- A Swiss-resident capital company that is subject to corporation tax in Switzerland without benefiting from an exemption.
- A company resident in a treaty country and meets the Comparable Tax Test as discussed in **Subject to Tax**, above.

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

- The dividend is paid to one of the abovementioned qualifying entities that holds 10% or more of the issued share capital of the Luxembourg company (whether via an entity that is transparent for Luxembourg tax purposes or not), or the participation has an acquisition cost of at least €1.2 million.
- The qualifying entity has held, or commits itself to continue to hold, a minimum participation as mentioned above for an uninterrupted period of at least 12 months.<sup>4</sup>

Shareholders that are considered as transparent for Luxembourg tax purposes should be disregarded when determining whether the above conditions are met. Instead, the indirect non-tax transparent shareholders should be regarded as owning the participation in the Luxembourg company.

In a manner that is similar to testing the application of the participation exemption discussed above in **General/Participation Exemption** before an exemption from withholding tax on dividends is applied to an E.U.-resident corporation, the

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<sup>4</sup> In recent practice, prior to the completion of the 12-month holding period, the L.T.A. may request that the fulfillment of this requirement must be guaranteed by way of a commitment letter from the shareholder.



arrangement by which the S.O.P.A.R.F.I. is held must be tested under the European G.A.A.R. of the P.S.D. as implemented in Luxembourg law. An improper, non-commercial purpose for the holding may prevent the application of the exemption. For non-E.U. shareholders, no such test is applicable. In addition, the Luxembourg domestic withholding tax exemption may be available notwithstanding the G.A.A.R., if the shareholder meets the Comparable Tax Test as referred to in item (d) above and further detailed above in **Subject to Tax**, which should be the case in the context of an income tax treaty as well as for many shareholders that are entities resident in an E.U. Member State. In this respect, reference must however be made to the potential future impact of the Multilateral Instrument as discussed in **Withholding Tax in a Foreign Subsidiary's Country** and recent case law of the E.C.J. discussed below in **Dividends**.

### **Interest Payment on Straight and Hybrid Debt**

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

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 such as the U.S.<sup>5</sup> 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. that are referred to above in **General/Participation Exemption**, the use of hybrid instruments may be limited where two E.U. Member States are concerned. In addition, effective January 1, 2019, Luxembourg, has implemented the Anti-Tax Avoidance Directive (2016/1164) ("A.T.A.D.") and Directive Anti-Tax Avoidance 2 (2017/952) ("A.T.A.D. 2") which, under certain conditions, bars the deduction of interest paid on hybrid instruments issued by a Luxembourg company, as well as the deduction of interest paid on instruments held by a hybrid entity. See the discussion below at **Hybrid Mismatch Rules and Reverse Hybrid Mismatch Rules**.

## **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

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While outside of the scope of this chapter, the 2017 U.S. Tax Cuts & Jobs Act enacts anti-hybrid rules that eliminate the benefit of the dividends received deduction for a U.S. corporation owning 10% or more of the shares of a foreign company. This provision causes payments under a C.P.E.C. to be treated as fully taxable dividends that do not bring along indirect foreign tax credits and that do not qualify for the foreign source dividends received deduction under Code §245A.

- 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.

A repurchase of shares in a S.O.P.A.R.F.I. should be considered as a capital gain and not subject to Luxembourg dividend tax. However, following a case dated 2017,<sup>6</sup> the repurchase could be viewed in certain circumstances as a “simulated” dividend that is subject to dividend tax (if no exemption applies). Typically, the risk of this type of challenge exists when the repurchase price is not supported by valid economic principles or when the repurchase should be viewed as a fictional, simulated transaction, and in fact the intention was to distribute profits out of the company to the shareholder.

The risk becomes remote when the transaction involves a repurchase by the company and an immediate cancellation of all shares from one or more shareholders, who cease to be shareholders. In this fact pattern the repurchase is considered to be a capital gain, that is not subject to Luxembourg dividend tax (the “partial liquidation”) by virtue of Article 101 of the I.T.A.

Traditionally, on the basis of administrative practice, the repurchase and immediate cancellation of an entire class of shares may also qualify as a partial liquidation, even if the shareholder owns other classes. While currently this is not scrutinized under the E.U. State Aid rules, it is advisable to assess whether the scheme could be considered as providing a selective advantage, which is the key criterion for the existence of unlawful State Aid.

In addition, following the abovementioned case law, it could be argued that the repurchase and immediately subsequent cancellation of an entire class of shares does not qualify as a partial liquidation, and could instead be a simulated dividend.

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<sup>6</sup> Administrative Court, March 3, 2017, no. 39193C.

## OTHER TAX ISSUES

### Debt-to-Equity Ratio

Luxembourg law does not contain any provisions regarding debt-to-equity ratios, other than the general arm's length principle. However, a debt-to-equity ratio of at least 85:15 is generally required by the Luxembourg tax authorities for the financing of qualifying participations. If a higher ratio is maintained, a portion of the interest payments may be considered as a deemed dividend, which will not be deductible for Luxembourg corporation income tax purposes, and, depending on the case, a Luxembourg dividend withholding tax obligation may arise.

In addition, Luxembourg tax authorities have published a Circular in transfer pricing matters which is discussed below in **Transfer Pricing Regulations**. This circular requires intra-group financing companies to be funded with an appropriate amount of equity in order to have the financial capacity to assume the economic risks of loan investments without actually specifying what an "appropriate amount of equity" is (*i.e.*, no set formula has been provided). Thus, the amount of equity to be contributed to a group financing company is a factual question and should be determined on a case-by-case basis.

### Transfer Pricing Regulations

To strengthen the transparency of Luxembourg transfer pricing legislation, the arm's length principle has been codified in Article 56 of the I.T.A. as of January 1, 2015, and Article 56*bis* of the I.T.A. as of January 1, 2017. The wording of Article 56 of the I.T.A. is based on Article 9 of the O.E.C.D. Model Tax Convention. The legislation stipulates that upon the request of the tax authorities, the taxpayer is obliged to present relevant information underlying the transfer prices agreed upon between associated enterprises. Based on the literal wording of Article 56, there are arguments to support that Luxembourg companies should be allowed to deduct a deemed interest expense on interest-free debt for C.I.T. and M.B.T. purposes, though such position is being challenged by the European Commission ("the Commission") in the *Huhtamaki* case discussed below in **State Aid Investigations by the European Commission**.

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

On December 27, 2016, the Luxembourg tax authorities published the Circular to Articles 56 and 56*bis* 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 €2.0 million to be adequate. The Circular, however,

*“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. . .”*

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, as discussed in **Advance Tax Agreements and Advance Pricing Agreements**.

### **Capital Duty**

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

### **Annual Net Worth Tax**

A S.O.P.A.R.F.I. is subject to an annual net worth tax, which is levied at the rate of 0.5% of the company's worldwide net worth on January 1 of each year, evaluated on

the basis of the company's balance sheet as at December 31 of the preceding year. A reduced rate of 0.05% applies for taxable net wealth in excess of €500 million.

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

A fixed minimum net worth tax applies, set at €4,815 (including a 7% surcharge), based on the closing balance sheet of the preceding year, when the resident corporate taxpayer's financial assets for the prior year exceeded 90% of its total balance sheet and the balance sheet total exceed €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, the latter maximum applying in case of a balance sheet total exceeding €30 million.

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

The fixed minimum tax is reduced by any C.I.T. (including the 7% surcharge) due for the preceding tax year.

Subject to certain conditions, a S.O.P.A.R.F.I. can credit part of its preceding year C.I.T. against the net worth tax of a given year. This will require, however, that the S.O.P.A.R.F.I. creates a non-distributable reserve of five times the amount of the credit it is seeking and keeps such reserve in place for at least five years.

### **Real Estate Tax for Investment Vehicles**

Certain investment vehicles are subject to a real estate tax on income derived from real estate assets situated in Luxembourg. The tax is imposed at a flat rate of 20%.

The investment vehicles that are within the scope of this new tax are specialized investment funds ("S.I.F."), so-called "Part II" undertakings for collective investment ("U.C.I."), and reserved alternative investment funds ("R.A.I.F"), provided the vehicle in issue is not, briefly put, a tax transparent partnership or a common placement fund ("F.C.P."). The tax applies to income and gains derived from Luxembourg real estate assets held directly and indirectly via a partnership or an F.C.P.

Income derived from real estate assets income includes (i) gross rental income, capital gains upon the disposal of a Luxembourg real estate asset (at the moment of a sale, contribution, merger, liquidation, etc.) and (ii) income from the disposal of interest in certain tax transparent entities (a partnerships or an F.C.P.), to the extent the value of these "shares" reflects the value of real estate located in Luxembourg, including when these transfers do not lead to cash event (e.g., intragroup restructuring).

The L.T.A. released an administrative circular which clarified the filing obligations required by the Real Estate Levy for Investment Fund Vehicles. By May 31, 2022, all

investment vehicles under the scope of the Real Estate Levy (*i.e.*, S.I.F.'s, U.C.I.'s and R.A.I.F.'s) whether they ultimately derive income from real estate situated in Luxembourg or not need to report the following:

- Whether or not they directly owned a real estate asset situated in Luxembourg during the years 2020 and 2021
- Whether or not they owned a real estate asset situated in Luxembourg during the years 2020 and 2021 through a tax transparent entity or an F.C.P.
- Whether or not they changed their corporate form during the years 2020 and 2021 to become tax transparent or adopted the form of an F.C.P., and whether or not they owned – at the moment of the change of form – at least one real estate asset situated in Luxembourg, either directly or through a tax transparent entity or an F.C.P.

Investment vehicles inside the scope of the Real Estate Levy which hold Luxembourg real estate will have to file a return declaring the qualifying real estate income (with a detailed breakdown of each property) by May 31 of the following year.

### **Advance Tax Agreements and Advance Pricing Agreements**

The procedure to obtain an A.T.A. is codified into Luxembourg law. In an A.T.A., the 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.

A.T.A.'s obtained by a taxpayer are binding on the tax authorities unless one of the requirements set out in the law is no longer met. A.T.A.'s obtained prior to the introduction of the legal framework for obtaining advance confirmation in 2015 are in most cases valid indefinitely, unless

- the circumstances or transactions were described incompletely or inaccurately,
- the circumstances or transactions that took place at a later stage differ from those underlying the A.T.A., or
- the A.T.A. is no longer compliant with national, E.U. or international law.

Subject to the foregoing requirements, case law<sup>7</sup> provides that an A.T.A. continues to bind the Luxembourg tax authorities notwithstanding a change of policy under the following conditions:

- The question and fact pattern submitted to the tax authorities are clear and included all elements necessary to allow the tax authorities to make an informed decision.
- The decision was issued by a competent civil servant, or by a civil servant of which the taxpayer could legitimately believe that he was competent.

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<sup>7</sup> Administrative Court, July 12, 2016, no. 37448C.



- The administration intended to bind itself, *i.e.*, the answer was given without restrictions or reservations.
- The answer provided by the administration must have had a decisive influence on the taxpayer.

However, a law voted on December 20, 2019, provides for the automatic expiration of A.T.A granted prior to 2015 expired upon completion of the 2019 tax year. Taxpayers should still be able to rely on their pre-2015 A.T.A. for the tax years up to 2019, as long as they have not already been invalidated by the above-mentioned doctrine. Should taxpayers want similar comfort for subsequent tax years, a new request may be filed under the new procedure. The explicit language of the law to that effect seems to imply that the fact that a new ruling request would be filed only after the transaction had occurred should not be an obstacle to obtaining such a ruling.

As for intra-group transactions, the arm's length character of the remuneration to be earned by a Luxembourg company may be confirmed by the tax authorities in an advance pricing agreement ("A.P.A"). However, the issuance of an A.P.A. is subject to certain conditions, set out in an administrative circular issued by the Luxembourg tax authorities on December 27, 2016 (the "Circular"). Such conditions include, *inter alia*, the following:

- The relevant employees or board members of the Luxembourg entity are qualified to carry out the functions and tasks assigned to the Luxembourg entity.
- The countries affected by the financing transactions have been listed.
- Full information has been provided regarding the parties involved in the controlled transaction.
- A detailed transfer pricing analysis has been submitted. See **Transfer Pricing Regulations**.

### **State Aid Investigations by the European Commission**

Over the last few years, the Commission has continued its examination of the A.T.A. and A.P.A. practices of various E.U. Member States, including Luxembourg, in light of the existence of unlawful State Aid by way of an A.T.A. or A.P.A. The Commission has repeatedly stated that an A.T.A. or A.P.A. that merely confirms in advance the application of tax law in a particular case is legitimate. On the other hand, an A.T.A. or A.P.A. that grants State Aid is not allowed under the E.U. treaties. In that regard, it is generally unlawful for E.U. Member States to grant aid in the form of a tax advantage on a selective basis to undertakings. If unlawful aid was granted, the Commission can order the Member State to recover that aid from the beneficiary undertaking, with interest due on the collected amount, as if it were a loan.

Regarding Luxembourg, the Commission has investigated (or is investigating) A.T.A.'s issued to GDF Suez, Amazon, McDonald's, Fiat Finance and Trade ("F.F.T."), and Huhtamaki to determine whether A.T.A.'s amounted to unlawful State Aid.

On October 21, 2015, the Commission's adverse decision with regard to the F.F.T. case was published (Decision C(2015) 7152 final), stating that Luxembourg granted selective tax advantages to F.F.T. The Commission ordered Luxembourg to recover



the unpaid tax from F.F.T. in order to remove the unfair competitive advantage they were granted and to restore equal treatment with other companies in similar situations. In addition, F.F.T. can no longer continue to benefit from the tax treatment granted by these tax rulings. The E.U. General Court also upheld the Commission's decision in the Fiat case, maintaining that Luxembourg granted unlawful State Aid to a Luxembourg treasury company of the Fiat group. The General Court criticized specific aspects of the transfer pricing position. In particular, it questioned the amount of equity deemed at risk, which was seemingly much lower than the equity in reality at risk, and the application of the equity at risk remuneration only to that small portion of equity deemed at risk.

On October 4, 2017, the Commission reached an adverse decision in the Amazon case (Decision (E.U.) 2018/859). The case concerns the arm's length nature of royalty paid by a Luxembourg company to a Luxembourg partnership. The decision ordered Luxembourg to recover the granted State Aid from Amazon. Luxembourg challenged the decision to the European Union General Court (case T-816/17). On May 12, 2021, the General Court of the E.U. annulled the Commission which found that Luxembourg granted unlawful State Aid to Amazon. The Commission filed an appeal with the Court of Justice of the E.U. which is still pending.

On June 20, 2018, the Commission reached an adverse decision in the Engie case (Decision (E.U.) 2019/421). The case concerns the tax position of three companies involved in a domestic "hybrid" instrument structure and whether Luxembourg should have applied its domestic anti-abuse rule. The Commission found that Luxembourg granted unlawful State Aid to Engie. Luxembourg appealed this decision to the European Union General Court (cases T-525/18 and T-516/18, respectively). On May 12, 2021, the General Court of the E.U. upheld the Commission decision of June 2018, finding that Luxembourg granted unlawful State Aid to Engie. Engie and Luxembourg filed an appeal with the Court of Justice of the E.U. which is still pending.

On September 19, 2018, the Commission took a positive decision in the McDonald's case stating that Luxembourg did not grant McDonald's a selective advantage (Decision C(2018) 6076 final). The case concerned mismatch in the context of U.S. branch.

On May 3, 2019, the Commission published its opening decision (Decision C(2019) 1615 final dated March 7, 2019) in the Huhtamaki case, which concerns A.T.A.'s issued by the Luxembourg tax authorities to the Finnish packaging group in 2009, 2012, and 2013. These rulings concern a Luxembourg intra-group financing company funded with interest-free loans ("I.F.L.") granted by an Irish sister company. The A.T.A.'s allowed the Luxembourg company to impute a deduction for deemed interest expenses on the I.F.L. for M.B.T. and C.I.T. purposes. In the Commission's view, such downward adjustment constitutes a selective advantage which deviates from Luxembourg's reference system (*i.e.*, its corporate income tax).

## **S.I.C.A.R.**

The S.I.C.A.R. law provides a flexible and tax-favorable regime for any investments in risk-bearing capital. The purpose of this law is to facilitate private equity and venture capital investments within the E.U.

*“The R.A.I.F. is an attractive regime created in July 2016. It allows for flexible establishment and operating rules. . .”*

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

In principle, a S.I.C.A.R. organized as a capital company is fully taxable for C.I.T. purposes. However, income realized in connection with its investments in risk-bearing securities is fully exempt from C.I.T. Other income, such as interest accrued on bank deposits, management fees, and the like, is normally taxed. In a cross-border situation, the Luxembourg tax authorities take the position that a S.I.C.A.R. is entitled to the benefits of the Luxembourg tax treaties and the P.S.D. In addition, a S.I.C.A.R. is exempt from net worth tax (except for minimum net worth tax of €4,815) and from withholding tax on dividend distributions. Nonresident investors in a S.I.C.A.R. are not subject to Luxembourg taxes on dividends distributed or capital gains realized on the disposal of the shares in the S.I.C.A.R. A S.I.C.A.R. is subject to the minimum tax rules, as described above in **Capital Duty**.

A S.I.C.A.R. organized as a limited partnership is not subject to C.I.T. due to its tax transparency. As a result, its profits will not be liable to Luxembourg income taxes (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 regime created in July 2016. It allows for flexible establishment and operating rules: its setup does not require approval by the C.S.S.F., and it is also allowed certain structuring features which at present are only available to regulated A.I.F.’s (e.g., umbrella structure, variable capital, specific tax regime). In addition, access to the marketing passport as per Directive 2011/61/E.U. on A.I.F. managers (the “A.I.F.M.D.”) is available, and investors’ protection is ensured by the full application of the A.I.F.M.D. regime at the manager’s level.

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

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

## SECURITIZATION VEHICLES

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

The S.V. Law defines “securitization” very broadly:

The transaction by which a securitization vehicle acquires or assumes, directly or through another vehicle, the risks relating to claims, obligations, and other assets or to the activity of a third party by issuing securities the value or the yield of which depends on such risks.<sup>8</sup>

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

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

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

Securitization vehicles are, in principle, fully subject to Luxembourg C.I.T. at the standard combined rate of 24.94% (for Luxembourg City in 2022). However, the securitization vehicle is able to deduct from its taxable base all “commitments” owed to investors and creditors subject to the interest deduction limitation rules referred to above in **Interest Payment on Straight and Hybrid Debt**. A commitment should be interpreted as including all payments declarations, or properly accrued amounts, either in the form of interest or dividends, made by the securitization vehicle to its investors and creditors. The taxable result of the company can be virtually reduced to nil, albeit that a securitization vehicle is subject to the minimum tax described above in **General/Participation Exemption**. Securitization vehicles set up in the form of a fund are considered transparent for 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

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<sup>8</sup> Article 1(1) of the law of March 22, 2004, on securitization.

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 (except for minimum net worth tax).

## RECENT AND CURRENT DEVELOPMENTS

### **The Concepts of “Beneficial Owner” and “Abuse” Under E.C.J. Case Law**

The E.C.J. issued several judgments<sup>9</sup> addressing the concepts of “beneficial owner” and “abuse” under the Interest and Royalty payments Directive (2003/49/E.C.) (the “I.R.D.”) and the P.S.D. The targeted structures all had in common the use of intermediate holding companies that could claim the benefit from withholding tax exemption on interest/dividend payments within the group on the basis of the I.R.D. and the P.S.D. The E.C.J., however, denied the benefit from the I.R.D./P.S.D. considering that the recipient companies of the interest/dividend payments were not the ultimate beneficial owner. In that respect, the E.C.J. identified the beneficial owner as the entity which actually benefits from that interest economically, and accordingly has the power to freely determine the use to which it is put.

In addition, the judgments provide useful indicators on how to apply the abuse concept, which requires first identification of an “artificial arrangement.” An arrangement is identified as artificial if the principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law.<sup>10</sup> The E.C.J. further illustrated the concept of abuse by providing different situations that may constitute an abuse. All of them concern situations in which the recipient of the interest payments, claiming the I.R.D.'s benefit, merely acts as a conduit company. The E.C.J. also took into consideration the way in which the transactions are financed, the valuation of the intermediary companies' equity, and the conduit companies' inability to have economic use of the income received.

Although the indicators are presented in an E.U. directive context, tax authorities may take the position that they are relevant in a tax treaty context, as the P.P.T. introduced under the Multilateral Instrument uses very similar concepts, as discussed above in **Withholding Tax in a Foreign Subsidiary's Country**.

### **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

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<sup>9</sup> The four joined cases were all rendered on February 26, 2019, case N Luxembourg 1 (C-115/16), X Denmark (C-118/16), C Denmark 1 (C-118/16), and Z Denmark case (C-299/16), in addition to two additional joined cases (case T Denmark (C-116/16) and Y Denmark Aps (C-117/16)).

<sup>10</sup> This is a lower threshold than the “wholly artificial” requirement derived from the *Cadbury Schweppes* case law (case C-196/04, September 12, 2006).

24, 2015. Reporting Luxembourg financial institutions must give specified information on their U.S. account holders to the Luxembourg tax authorities, which in turn pass that information to the U.S. I.R.S.

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

On December 8, 2015, the E.U. Council adopted Directive 2015/2376/E.U. (the "E.O.I. Directive") amending Directive 2011/16/E.U. regarding the mandatory automatic exchange of information in the field of taxation. The E.O.I. Directive was implemented in Luxembourg by law on July 23, 2016, and 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 to January 1, 2017. Only rulings involving cross-border transactions are covered by the E.O.I. Directive, and rulings concerning only natural persons are excluded.

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

Finally, as a result of the implementation into the laws of the Member States of the E.U. Directive (E.U./2018/822) introducing mandatory disclosure rules (the "Mandatory Disclosure Directive"), advisers, other intermediaries, and taxpayers may be legally required to disclose information to E.U. Member States' tax authorities on certain advice given and services rendered regarding cross-border tax planning arrangements that qualify as reportable cross-border arrangements. The domestic law relating to the Mandatory Disclosure Directive entered into force on January 1, 2021. In addition, each relevant taxpayer will have to annually disclose in his tax return how he has used the arrangement.



## **Country-by-Country Reporting**

On December 13, 2016, the Luxembourg Parliament adopted a law on Country-by-Country Reporting (“C.b.C. Reporting”), in accordance with E.U. Directive 2016/881 of May 25, 2016, requiring the implementation of a C.b.C. Reporting obligation in Member States’ national legislation. The obligation to prepare a C.b.C. Report applies to large multinational enterprise groups 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 C.b.C. 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 deadline for the submission of C.b.C. Reports is 12 months after the last day of the relevant fiscal year. In addition, each Luxembourg entity that is part of a multinational enterprise group must notify the Luxembourg tax authorities on an annual basis of the identity of the entity that will be filing the C.b.C. Report for the year concerned. The deadline for this notification is the last day of the fiscal year of the multinational enterprise group.

## **U.B.O. Register**

On January 13, 2019, Luxembourg published a new law with regard to the implementation 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.”), introducing a publicly-accessible register of ultimate beneficial owners (the “U.B.O. Register”). The entities falling within the scope of the law (*i.e.*, Luxembourg civil and commercial companies, European interest groupings, and Luxembourg branches of foreign entities) must disclose relevant information related to their U.B.O.’s to the U.B.O. Register within a month of becoming aware of an event that triggers registration or amendment to the information previously disclosed.

A U.B.O. is any natural person who ultimately owns or controls the company through (i) direct or indirect ownership of more than 25% of the shares or voting rights or ownership interest in that company or (ii) through control via other means.

The information to be disclosed for each U.B.O. includes the full name, place and date of birth, address, national identification number, nationality, and country of residence. Apart from the private or professional address and the identification number, such information will be publicly available. As an exception thereto, a duly motivated request can be filed for the information not to be publicly available. If such request is approved, which will occur only in exceptional circumstances, access to the information will be limited to national authorities (*e.g.*, the Luxembourg tax authorities) or financial institutions.

For Luxembourg companies, non-compliance may result in a criminal fine ranging from €1,250 to €1,250,000. A U.B.O. that does not comply with their obligation to cooperate with the Luxembourg company may also receive a criminal fine ranging from €1,250 to €1,250,000.

## **I.P. Regime**

On March 22, 2018, Luxembourg adopted a new I.P. regime set out in article 50ter I.T.A. (the “New I.P. Regime”) effective January 1, 2018. The New I.P. Regime applies to any Luxembourg tax resident carrying out a business activity in Luxembourg and owning qualifying I.P.

Eligible net income from qualifying I.P. assets may benefit from an exemption up to 80% from income taxes and a full exemption from net wealth tax. The eligible assets must have been developed or improved after December 31, 2007, and are limited to patents, utility models, supplementary protection certificates granted for a patent on medicine and plant protection, plant variety certificates, extensions of a complementary protection certificate for pediatric use, orphan drug designations, and software protected by copyrights.

The portion of the I.P. income benefiting from the advantageous tax treatment is calculated based on a ratio taking into account the R&D costs. The ratio corresponds to the eligible R&D costs divided by the overall R&D expenses. Luxembourg allows the eligible R&D costs to be uplifted by 30% insofar the resulting ratio does not exceed the total amount of expenditure. Expenses must be incurred within the framework of an R&D activity but need not be undertaken by the taxpayer. Outsourced activity is eligible for favorable treatment.

The New I.P. Regime is in line with the recommendations made by the O.E.C.D. and adopts a nexus approach to ensure that only the R&D activities having a nexus with the Luxembourg taxpayer itself benefit from the New I.P. Regime.

Unlike the previous regime, I.P. assets of a marketing nature (e.g., trademarks) are excluded from the scope of the proposed regime.

The former I.P. regime was abolished in 2016 but continued to be applicable due to a grandfathering period of five years. Where the taxpayer is eligible under both regimes, the taxpayer may elect the I.P. regime to be applied during the transitional period (2018 to 2021). The option is irrevocable for the entire transitional period.

## **A.T.A.D. 1 and 2**

A.T.A.D. forms the E.U.-wide implementation of Action 2 of the O.E.C.D.’s work on base erosion and profit shifting (“B.E.P.S.”), which called for rules to neutralize the effects of hybrid mismatch arrangements through deduction limitations and a general anti-abuse rule.

In this context, A.T.A.D. 1 and the A.T.A.D. 2, together referred to as the “A.T.A.D.’s,” have been adopted by the E.U. Council. The main goal of the A.T.A.D.’s 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

*“Eligible net income from qualifying I.P. assets may benefit from an exemption up to 80% from income taxes and a full exemption from net wealth tax.”*

- Controlled foreign corporation (“C.F.C.”) legislation
- Hybrid mismatch rules and reverse hybrid mismatch rules

The implementation date was January 1, 2019, except for the exit taxation provision (January 1, 2020), the hybrid mismatch rules to the extent they concern third countries (January 1, 2020), and the reverse hybrid mismatch rules (January 1, 2022). In Luxembourg the law implementing A.T.A.D. 1 provisions into national law was published on December 21, 2018, and A.T.A.D. 2 on December 20, 2019.

### Interest deduction limitation rule

The interest deduction limitation rules cap the deductibility of “exceeding borrowing costs” at the highest of 30% of the E.B.I.T.D.A. or €3.0 million. This refers to the excess, if any, of a Luxembourg taxpayer’s deductible interest and economically equivalent expenses over such taxpayer’s taxable interest income and economically equivalent income. A grandfathering provision states that loans that were concluded prior to June 17, 2016, and that were not subsequently modified are not subject to the interest deduction limitation rules. Luxembourg companies that are part of a fiscal unity apply the interest deduction limitation rules at the level of the integrating company (unless a request is made for application at individual entity level).

The following three categories of Luxembourg taxpayers, *inter alia*, are excluded altogether from the application of the interest deduction limitation rules:

- A taxpayer that constitutes a financial undertaking which is, *inter alia*, the case if the taxpayer is an A.I.F or securitization vehicle in the sense of the E.U. regulation 2017/2402<sup>11</sup>
- A taxpayer that qualifies as a Standalone Entity, which means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no Associated Enterprise (as defined hereafter) and has no permanent establishment in another jurisdiction. An Associated Enterprise means (i) an entity (capital company, partnership, etc.) in which the taxpayer holds directly or indirectly 25% or more of the voting rights or capital ownership or is entitled to receive 25% or more of the profits of such undertaking or (ii) an individual or collective undertaking (capital company, partnership, etc.) which holds directly or indirectly 25% or more of the voting rights or capital ownership of the taxpayer or is entitled to receive 25% or more of the profits of the taxpayer.
- A taxpayer that qualifies for the “Group Ratio Exclusion,” which is the case if the following conditions are cumulatively met:
  - The taxpayer is a member of a consolidated group for financial accounting purposes.
  - The ratio of equity over total assets (the “Equity Ratio”) of the consolidated group does not exceed the Equity Ratio of the taxpayer by more than 2 percentage points (e.g., if the Equity Ratio of the consolidated

<sup>11</sup> The exemption for securitization vehicle is likely to be removed by the Luxembourg legislator pursuant to a pending bill of law, due to a letter of formal notice sent by the E.U. Commission as from January 1, 2023.



group is 10%, this condition is met as long as the taxpayer's Equity Ratio is at least 8%).

- All assets and liabilities are valued using the same method as in the consolidated financial statements established in accordance with I.F.R.S. or the national financial reporting system of an E.U. Member State.
- The taxpayer has filed a request to benefit from the Group Ratio Exclusion.

### Exit Taxation

The scope of Luxembourg's existing exit tax payment deferral will be limited and brought in line with the A.T.A.D.'s, *i.e.*, a 5-year tax payment deferral will apply to transfers to an E.U./European Economic Area jurisdiction, whereas under the current rules the deferral applies until the underlying asset is alienated, so theoretically indefinitely. The situations in which exit tax is due are extended to cover the transfer of isolated assets abroad. No guarantee requirement or interest will apply to the deferral. Exit tax payment deferrals granted for periods ending before January 1, 2020, are grandfathered. Conversely, companies migrating to Luxembourg or transferring their assets to Luxembourg will explicitly benefit from a step-up.

### General Anti-Abuse Rule ("G.A.A.R.")

The wording of the existing domestic G.A.A.R. provision was brought in line with the A.T.A.D.'s wording, introducing the concept of a non-genuine arrangement. It will suffice for a tax advantage to be one of the main purposes of the arrangement to be caught under the G.A.A.R.

### C.F.C.

As far as the C.F.C. legislation is concerned, Luxembourg opted essentially to provide that where a C.F.C. has been put in place for the purpose of obtaining a tax advantage, Luxembourg corporate taxpayers will be subject to C.I.T. on the undistributed net income of a C.F.C., *pro rata* to their ownership or control of the foreign branch or the indirectly held subsidiary, but only to the extent such income is related to significant functions carried out by the Luxembourg corporate taxpayer. To the extent that a Luxembourg company can establish, on the basis of adequate documentation of its activities or functions, or both, that it does not perform significant functions related to the C.F.C.'s activities, the C.F.C. rules should not have an adverse tax impact.

### Hybrid Mismatch Rules and Reverse Hybrid Mismatch Rules

A.T.A.D. 2 rules seek to prevent mismatch outcomes that arise as a consequence of the hybrid nature of a financial instrument, legal entity, or permanent establishment ("P.E."). Targeted mismatch outcomes are deduction non-inclusion, double deduction, and double nontaxation. The main concern in Luxembourg will be the following:



- Potential denial of deduction of a payment made under a hybrid instrument or made by/to a hybrid entity
- Application of corporate income tax on all or part of Luxembourg transparent entities' income

For the “ordinary” hybrid rules to apply, the mismatch must arise between associated entities or as part of a structured arrangement. When a person acts together with another person with respect to the voting rights or capital ownership in an entity, their participations in the entity will be aggregated in order to determine whether they are “associated” with that entity.<sup>12</sup>

Upon request, taxpayers must provide the tax administration with relevant documentation reasonably proving the absence of a hybrid mismatch or that another country has already tackled the hybrid mismatch. Relevant documents include tax returns and certificates from foreign tax authorities.

#### **Definition of Permanent Establishment**

In the same law as the one transposing A.T.A.D., the Luxembourg legislature took the opportunity to revise its definition of a P.E. As of January 1, 2019, the Luxembourg tax authorities can challenge the application of the exemption of income allocable to a P.E. under an applicable tax treaty pursuant to a provision in new Luxembourg law regarding the domestic interpretation of the P.E. concept. The Luxembourg tax authorities may ask for proof of existence of the P.E. from the treaty partner jurisdiction. Such proof is mandatory if the tax treaty does not have a clause that allows Luxembourg to deny the exemption under the applicable treaty if the other treaty partner does not impose tax on the income. Administrative guidance from the Luxembourg tax authorities makes it clear that the absence of such confirmation will result in the denial of the P.E. exemption. Obtaining such proof should be closely monitored.

#### **Denial of Deduction for Interest and Royalties Payments to Blacklisted Jurisdictions**

The Luxembourg government voted to enact a law implementing guidelines approved by the Council of the E.U. on December 5, 2019. Effective since March 1, 2021, deductions claimed for of interest and royalty payments accrued or paid by Luxembourg companies are disallowed when the recipient is resident in a blacklisted jurisdiction. The disallowance is subject to the following conditions:

- The recipient of the payment, or its beneficial owner if different, is a collective undertaking (meaning any collective vehicle of private law that is not transparent for tax purposes).

<sup>12</sup>

Luxembourg law provides that, in the absence of evidence to the contrary, an investor who owns (directly or indirectly) less than 10% of the interests in an investment fund and is entitled to less than 10% of the profits of said fund will not be considered as acting together with other investor(s) in the same fund.

- The recipient (or beneficial owner) is a related enterprise.<sup>13</sup>
- The recipient (or beneficial owner) is established in a jurisdiction which is included on the list of noncooperative tax jurisdictions.

The taxpayer's deductions will not be disallowed if it proves that the transaction is motivated by valid business reasons reflecting economic reality. The Luxembourg list of noncooperative tax jurisdictions will adopt the E.U. blacklist. It will be revisited only at each year end. Therefore, if a country is added during a year, it will first be included in the list only as of the beginning of next following year. If a country is added and subsequently removed from a list during a year, it will not be put in the list of the next following year. If a country is removed from the E.U. list, the removal will take effect from the date of publication of the removal by the E.U.

### Claim and Tax Objections

The deadline for filing a claim (*réclamation*) against a decision of the Luxembourg tax authorities is three months from the notification of the assessment. For now, the regular objection deadline still applies.

After the decision of the Luxembourg tax authorities, a taxpayer can object to the decision in front of an administrative court. The deadline for filing an objection against a decision is three months. The deadline for filing an appeal of a judgment of the administrative tribunal is 40 days.

### Substance in the Context of COVID-19

On March 20, 2020, a grand ducal regulation was issued regarding board and shareholder meetings. This regulation indicates that shareholder and board meetings can be held remotely (e.g., by video conference, written circular resolutions, a vote in writing, or electronic form, etc.). This regulation does not deal with the tax consequences of these measures.

The choice to hold board of directors meetings and shareholder meetings remotely might be problematic for tax residency purposes. Holding board of directors meetings in Luxembourg is an important element supporting the determination of the place of effective management of companies in Luxembourg. The O.E.C.D. also addresses the concern of the "change of the effective place of management" in its latest guidance. According to this guidance, the COVID-19 crisis is an extraordinary and temporary situation which should not trigger any change to the residence of a company under tax treaties.

In the absence of clear guidance from the Luxembourg tax authorities on the consequences of COVID-19 on substance and the application of the anti-abuse rule, these issues should be assessed on a case-by-case basis, notably considering the perspective of other countries where income arises.

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<sup>13</sup> Related enterprises have to be understood further to the transfer pricing concept (i.e., two entities that are participating in each other or in the same company through capital, control, or management).

# SWITZERLAND

## Author

Stephan Neidhardt  
Stephan Neidhardt Law & Taxes  
Zürich

## 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 corporate income tax rate for ordinarily taxed companies is 8.5%, but because taxes are deductible, the effective Federal income tax rate is 7.8%. The cantonal and communal corporate income tax rates depend on the company's location. The combined effective ordinary income tax rates (which include Federal, cantonal, and communal taxes) vary among the cantons. The combined rates of tax are as follows:

- 12.3% in Lucerne
- 13.0% in Appenzell Ausserrhoden
- 12.74% in Obwalden
- 11.97% in Nidwalden
- 11.84% in Zug
- 19.69% in Zürich
- 13.99% in Geneva

In addition to corporate income tax, capital taxes are imposed on the cantonal and communal level. No capital tax is imposed at the Federal level. On the cantonal and communal level, holding companies pay an annual capital tax in the range of one per thousandth ( $\text{capital} \times 0.001$ ) to 0.5%. The respective tax rates have been reduced dramatically in recent years, and in some cantons, it is possible to credit corporate income taxes against the capital tax. Moreover, the cantons may grant a substantial reduction on the equity base against which the capital tax is imposed where assets include participations, patents and similar rights and on loans to group companies. For example, in the canton of Zurich, the ordinary capital tax takes into account only 10% of those assets.

## TAXATION OF HOLDING COMPANIES

### **Preliminary Remarks in relation to the Abolition of Special Tax Regimes for Holding Companies**

In response to increasing international pressure, tax privileges such as the special regime for holding companies were abolished effective January 1, 2020.

While this may seem to be a substantial disadvantage for holding companies in comparison to the status quo prior to the reform, this is not the case. The privileged tax treatment of finance branches, mixed, domiciliary, principal and holding companies have been replaced by other, O.E.C.D.-compliant measures, such as the I.P. box, the R&D super deduction and the notional interest deduction. In addition, many cantons have reduced their corporate income and capital tax rates significantly as part of the reform, with the aim of retaining their attractive positions for locating a business presence.

Turning to holding companies, *pure* holding companies, *i.e.*, companies that have all income generated by qualifying dividends or capital gains, generally are not affected by the abolition of the holding privilege. Thanks to the participation relief discussed below at **Taxation of Holding Companies**, such companies are virtually exempt from Swiss income tax. In fact, taxes might even be lower due to the notional interest deduction (“N.I.D.”), as described below, and due to a lower capital tax on certain assets as described above.

### **Corporation Income Tax**

#### **General**

Holding companies are subject to corporate income tax levied at the Federal, cantonal and municipal level. The effective tax rate is 7.8% at the Federal level, and, depending on the location of the company, between roughly 4% and 12% at the cantonal/municipal level. As mentioned earlier, corporate tax rates vary from canton to canton and municipality to municipality.

In principle, all income is taxable. However, income attributable to foreign enterprises, foreign permanent establishments, or real estate located abroad is exempt from taxation in Switzerland. Apart from various measures reducing the corporate tax burden such as those mentioned above at **Taxation of Holding Companies**, domestic Swiss tax law grants participation relief for (i) dividend income and (ii) capital gains on qualifying participations in Swiss or foreign companies held for at least one year.

A qualifying participation with respect to (i) dividends is one in which at least 10% of the nominal share capital or reserves are held, or the fair market value of the participation is at least CHF 1 million. In contrast, the threshold of CHF 1 million is not available for capital gains relief. The participation relief is not an outright tax exemption, but rather a tax abatement mechanism. The corporate income tax liability will be reduced by the ratio of net dividend income, taking into account administrative and financing costs, to total net profit. As financing costs 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).

### *Tax Relief Measures Introduced as of January 1, 2020*

A mandatory patent box regime was introduced at the cantonal and communal level, providing for privileged taxation of income from patents and similar intellectual property rights. A broad tax exemption will apply to 90% of qualifying I.P. income, with each canton having the option to reduce (but not increase) the scope of income qualifying for such exemption. The O.E.C.D.'s nexus approach for I.P. regimes will be applied, *i.e.*, the R&D expenses need to be incurred through operations carried out by the patent box company itself. The patent box regime is not applicable at the Federal level.

A super-deduction of up to 150% for Swiss-performed R&D expenses may be introduced at the cantonal and communal tax level. Each canton is free to choose whether to enact such an incentive.

“High” corporate tax cantons may adopt legislation that grants an interest deduction on equity. This is the so-called notional interest deduction, or “N.I.D.” A high corporate tax canton is one where the effective income tax burden in the canton’s capital amounts to at least 18.03%. Among the high tax cantons of Zürich, Berne, and Aargau, only Zürich opted for the N.I.D. allowance, favoring companies that are highly financed with equity.

The sum of the combined benefits of the patent box treatment, R&D super-deductions, and N.I.D. may not exceed 70% of the overall taxable income for the relevant tax period.

### *15% E.U. Minimum Income Tax*

Switzerland is fully aware of the European Union’s plan to introduce a 15% minimum income tax. Some of the Swiss cantons will be subject to these rules, meaning that they must increase their income tax rates to at least 15% (including Federal income tax). At the moment, proposals and discussions are under way in order to compensate the companies affected by these rules. At this stage it is too early to guess where these discussions are going.

### **Capital Tax**

A local annual equity capital tax is levied at the cantonal and municipal level. As previously noted above in **In General**, there is no capital tax at the Federal level.

Most cantons have reduced their capital taxes recently. To illustrate, in the cantons of Obwalden and Nidwalden, the capital tax for all companies amounts to only one per thousandth ( $\text{capital} \times 0.001$ ) of the company’s total net equity measured at book value. Other examples are Schwyz (0.003%), Schaffhausen (0.005%), Zug (0.072%) and Lucerne (0.185%).

In addition, most cantons have mechanisms in place that result in a substantially reduced annual equity capital tax for holding companies. Some cantons such as Schwyz and Geneva allow corporate income taxes to be credited against capital tax. However, as the credit is not refundable, no benefit is obtained if no corporate income tax is due.

In Zug, Zürich, Graubünden and Lucerne, holding companies can benefit from a relief on equity relating to their qualifying participations. The tax base for the capital



tax is reduced by a certain percentage depending on the extent of qualifying participations.

### **Stamp Duty**

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

However, relief is available for shares 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 or note). In further illustration, the transfer of a participation of at least 10% to another company would also qualify as a tax neutral restructuring and, thus, benefit from the stamp duty exemption.

Unfortunately, the Swiss people recently voted down an initiative to delete the 1% stamp duty. However, it seems that initiatives are underway to increase the amount that is currently tax exempt from CHF 1 million to at least CHF 2 million.

### **Value Added Tax**

A Swiss holding company may be subject to V.A.T. at the present rate of 7.7% 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.

### **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 Swiss banking laws, investment fund managers, and Swiss companies holding securities with a book value exceeding CHF 10 million. The securities transfer tax is 0.15% of the sale price for Swiss securities and 0.3% for foreign securities. This amounts to 0.075% for Swiss securities and 0.15% for foreign securities 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 generally are subject to a 35% Swiss withholding tax, no

*“If the parent company is based in the U.S. or certain other countries, dividend distributions are subject to a reduced Swiss withholding tax. . .”*

matter the status and nature of the investor. It applies equally to private and institutional investors and to domestic and foreign investors. The repayment of nominal share capital and capital contribution reserves however is not subject to Swiss withholding tax. 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.

Withholding tax is perceived by many as an obstacle for Swiss capital markets. Although foreign investors are often entitled to a full or partial refund of the withholding tax based on a double tax treaty between Switzerland and their country of residence, the assertion of their right entails an administrative burden and a temporary liquidity shortage. In light of this, several attempts have been made to reform the Swiss withholding tax regime.

The Swiss Federal Council has proposed that Swiss interest-bearing investments will be exempt from withholding tax in the future for institutional and foreign investors. The Swiss people will likely vote on this proposal in September 2022. A positive result is expected to reverse the drop in Swiss financing business. In the case of individuals resident in Switzerland, withholding tax would continue to be levied, and foreign securities would also be subject to withholding tax.

### **Tax Credit for Foreign Withholding Taxes**

For nonrefundable foreign withholding taxes, Switzerland provides a limited tax credit (*“Pauschale Steueranrechnung”*). It is granted only for income arising in a foreign State with which Switzerland has concluded a double tax treaty. Switzerland allows relief in the form of a foreign tax credit for the unrecoverable portion of foreign withholding taxes.

The tax credit is limited to the Federal, cantonal and municipal tax payable in a relevant tax period, unless steps are taken in advance to counteract this limitation. No tax credit is allowed for income derived from qualifying participations benefiting from participation relief.



# ASPECTS OF SWISS INTERNATIONAL TAX LAW

## Swiss Tax Treaty Network

Switzerland has income tax treaties with over 100 jurisdictions, including all old and new E.U. Member States and the majority of Switzerland's important trading partners. It has also entered into several limited treaties regarding sea and air enterprises.

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

\* Treaty that includes a treaty abuse clause currently in force.

\*\* Treaty that includes a treaty abuse clause not yet in force.

New treaties with Armenia, Brazil, Ethiopia, Saudi Arabia, and Zimbabwe have been signed but are either not yet ratified or not yet in force. The proposed treaties with Brazil and Saudi Arabia include a treaty abuse clause.

Negotiations with other countries have taken place or are still under way. Such countries include Ethiopia, Bosnia and Herzegovina, Cameroon, Costa Rica, Libya, Nigeria, Senegal, and Syria.

Further discussions are under way regarding the existing treaties with Armenia, Germany, Israel, Japan, Kenya, North Macedonia, Russia, Rwanda, Singapore, Sri Lanka, and 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, hereinafter referred to as the “1962 Decree,” was amended at the end of 1998, and once again during 2010. The 1962 Decree and the subsequent circular letters issued by the Swiss Federal Tax Administration are designed to prevent the abuse of Swiss intermediary companies.

In general terms, the 1962 Decree characterizes certain transactions as a misuse of the treaties if 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 provides that tax-deductible payments by a Swiss entity have to be capped at 50% of the gross income that received withholding tax benefits under a double tax treaty. The 1962 Decree also mandates 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.

These unilateral rules apply in the absence of a specific treaty provision and only to payments made to a Swiss company.

Following the signing of the Multilateral Instrument (“M.L.I.”), which contains a wider reaching “principle purpose test,” the 1962 Decree was partially repealed in 2017 and transformed into an ordinance. See the discussion, below, at **Multilateral Instrument**.

### **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 25% dividend distribution requirement applies only 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 annual dividend distribution amounts



to less than 6% of total net equity. If all three conditions are met, withholding tax is imposed at the full rate, notwithstanding the terms of an income tax treaty.

### **2010 Circular Letter**

The 2010 Circular Letter clarifies that special anti-abuse provisions in double tax treaties take precedence over the 1962 Decree, including circular letters.

### **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.

### **Multilateral Instrument**

Switzerland has signed the M.L.I. to implement Tax Treaty-Related Measures to prevent Base Erosion and Profit Shifting. The Federal government announced that it will implement the minimum standards either within the framework of the M.L.I. or by means of the bilateral negotiation of double tax agreements.

Although not yet in force, agreements have been reached with each of the following jurisdictions:

- Argentina
- Austria
- Lithuania
- Luxembourg
- South Africa
- Turkey

The following countries have expressed their willingness to amend the existing income tax treaties with Switzerland in accordance with the M.L.I. in the near future:

- Chile
- Czech Republic
- Iceland
- Italy
- Portugal

It is expected that the M.L.I. minimum standard will be introduced into additional double tax treaties of Switzerland in the near future. This may be achieved with additional partner states if agreements on the technical implementation of the M.L.I. can be obtained or by means of bilateral income tax treaty amendments.

***“The Swiss parliament approved ratification of the M.L.I. on March 22, 2019, and the ratification bill has been deposited at the O.E.C.D.”***

Materially, the new treaty provisions resulting from the B.E.P.S. minimum standards accomplish the following:

- They modify the description of the treaty’s purpose in the preamble.
- They include a principle purpose test providing that a benefit under a tax treaty will not be granted if obtaining that benefit was one of the principle purposes of an arrangement or transaction.
- They adjust the provisions governing dispute resolution within the framework of mutual agreement procedures. In keeping with its treaty policy, Switzerland opts for the inclusion of the mandatory and binding arbitration clause provided for in the M.L.I.

The Swiss parliament approved ratification of the M.L.I. on March 22, 2019, and the ratification bill has been deposited at the O.E.C.D.

## **ADDITIONAL TAX-RELATED ISSUES**

### **U.S. Check-the-Box Rules**

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

### **Swiss Ruling Policy**

Switzerland is well known for the generally cooperative and taxpayer-friendly ruling policy of its tax authorities. Advanced rulings can be obtained from (i) the cantonal tax authorities with 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. are now 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 is debt-financed by related parties in excess of the maximum permissible percentage (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 generally are not tax deductible and will be requalified as deemed dividend distributions that are subject to Swiss withholding tax.

Nonetheless, a 2015 court decision approved interest expense deductions for higher amounts of interest where the taxpayer proves they meet the arm's length standard. To illustrate, the book value of improvements to real estate typically is reduced over time to reflect depreciation of buildings and structures. Nonetheless, the fair market value of the real estate may increase substantially, and unrelated lenders typically compute leverage capacity based on fair market value rather than the book value of the real estate. When real property is income producing, fair market value is determined by reference to the rental revenue generated.

If the interest rate on loans applied by a company is below the permissible maximum rate, interest payments on hidden equity will be tax-deductible to the extent of the differential amount between interest payments made and maximum interest payments allowed.

### **Step-up Upon Migration to Switzerland or Company Status Change**

When a foreign company is domesticated into Switzerland or a change occurs in a Swiss company's tax status, such as might occur from the termination of a special tax status, a tax-free step-up to fair market value will be allowed with regard to the basis of the assets reported on the company's tax balance sheet. This will result in an increase in the allowance for depreciation for Federal and cantonal tax purposes in Switzerland.

## **USE OF SWISS HOLDING COMPANIES**

Prior to the abolition of the complete income tax exemption on the cantonal and communal levels that became effective on January 1, 2020, Swiss holding companies were not permitted to conduct business in Switzerland in order to retain privileged tax status. These restrictions have now been lifted, enhancing the value of Swiss holding companies.

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

- An activity clause is not required for investments (*i.e.*, participations owned by a Swiss holding company can also be qualified as portfolio investments).
- A "subject-to-tax clause" does not exist for underlying participations.
- In connection with dividend distributions, there is no holding period requirement for investments.
- There is no capital gains tax on the sale of participations of 10% or more once a one-year holding period has been exceeded for the participation.
- Switzerland does not levy withholding tax on outbound royalties and outbound interest payments, with the exception of interest paid on bonds. This exception might, however, be ended soon, depending on the vote in September 2022.
- Switzerland does not have any C.F.C. legislation.

In light of recent initiatives focused on combatting base erosion and profit shifting and other ongoing changes in worldwide taxation principles, it is advisable for a



Swiss holding company to have substance in Switzerland in the form of office space that is actively used by competent personnel.

## COVID-19 MEASURES

The following were the main COVID-19 tax measures in Switzerland. As of 2022, they are no longer in force.

### **Deferred Filing Dates**

The filing deadlines for personal tax returns covering the year 2020 normally expired on March 31, 2021. Most of the Swiss cantons have extended these deadlines for several months and individuals can also ask for additional extensions, if necessary. A few cantons also introduced automatic extensions for legal entity tax returns covering 2020. All entities can also ask for additional and individual extension, if necessary.

### **Deferred Payment**

Many cantons have extended the payment terms for cantonal taxes, normally due in the course of 2021, until the December 31, 2021, without the imposition of late payment interest. The same is true for Federal income taxes 2020.

The accrual of late payment interest on V.A.T. and customs duties was suspended between March 20 and December 31, 2020. However, this does not change the duty to file V.A.T. declarations on time.

Companies and self-employed individual may ask for an interest-free payment deferral for social security contributions.

### **Extra Deductions for COVID-19 Losses**

As an exception to the general rule that expenses must be incurred in a period in which income is accrued, several cantons have announced the possibility of an extraordinary tax-deductible provision for cantonal and communal tax purposes in tax period 2020.

### **Stranded Individuals**

Generally speaking, cross-border commuters should not lose their special tax status when COVID-19 circumstances prevents them from fulfilling the conditions for such status. The same is true for cross border social security contributions where an individual worked for a reduced period of time in his country of domicile.

## NETHERLANDS

**Author**  
Sjoerd Stokmans  
Van Doorne  
Amsterdam

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 as follows:

- Access to an extensive tax treaty network, as well as access to a large network of bilateral investment treaties (each consisting of almost 100 treaties)
- The Dutch tax ruling practice
- The transparency of its holding regime

The foregoing benefits are supplemented by bilateral investment treaties that provide protection for investments of Dutch-resident entities when jurisdictions enact measures targeting foreign investors.

Nonetheless, in the last few years the Dutch tax climate is changing as a consequence of the discussions held within the E.U. and the O.E.C.D. New rules and regulations have been introduced to ensure that the Dutch tax system and its tax treaties cannot be misused by investors established in or using conduit companies established in low-tax jurisdictions.

## CORPORATION INCOME TAX – GENERAL

In principle, all income of a holding company will be subject to Dutch corporation income tax at the rate of 25.8% for profits exceeding €395,000. Profits up to €395,000 (the lower bracket) are taxed at a rate of 15.0%. In 2023, the high end of the lower bracket is scheduled to be decreased to €200,000.

## 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, discussed later in this chapter. No minimum holding period is required, although in a short term buy-and-sell transaction, part of the tax-exempt capital gains realized may be re-qualified as a taxable service fee. The participation exemption only applies if the interest held by the Dutch-resident taxpayer qualifies

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as a participation (“*deelneming*”). A participation exists if one of the following criteria is met:

- The Dutch taxpayer holds at least 5% of the nominal paid-up capital of a company with capital divided into shares.
- The Dutch taxpayer holds an interest in an “open” limited partnership that gives entitlement to at least 5% of the profits realized by the open limited partnership.
- The Dutch taxpayer holds at least 5% of the participating certificates of a fund for joint account.
- The Dutch taxpayer is a member of a cooperative.
- The Dutch taxpayer holds an interest that entitles it to at least 5% of the profits realized by a reverse hybrid entity. Such reverse hybrid entity qualifies as a participation if the entity is formed under Dutch law or established in the Netherlands, and at least 50% of the voting rights, capital interests, or profit rights in that entity are held directly or indirectly by one or more entities established in a state that considers the reverse hybrid entity to be nontransparent while the Netherlands would ordinarily consider it to be transparent. Where the above conditions are met, the interest in the reverse hybrid is considered a participation for a Dutch corporate shareholder meeting the 5% ownership condition, and in the absence of an applicable exemption, the entity become subject to Dutch corporate income tax and dividend withholding tax or conditional withholding tax.
- The Dutch taxpayer holds at least 5% of the voting rights in a company that is resident in an E.U. Member State with which the Netherlands has concluded a tax treaty that provides for a reduction of Netherlands dividend withholding tax based on voting rights.

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

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



## **Motive Test**

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

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

In comparison, the Motive Test is not met if the predominant function of the participation is to act as a group finance company or if more than half of the consolidated assets of the underlying company consist of shareholdings of less than 5%.

## **Subject-to-Tax Test**

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

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

## **Asset Test**

The Asset Test stipulates that the taxpayer must demonstrate that not more than 50% of the assets of the underlying company usually do not consist, directly or indirectly, of low-taxed, free passive assets. For this purpose, the assets must be considered at fair market value. The term “usually” implies that the participation exemption remains applicable if more than 50% of the assets of the participation consist of low-taxed, free passive assets for a short period of time 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 any of the following circumstances:

- The assets are passive assets that are not necessary for the business activities of the holder. Interest-bearing bank accounts, loan receivables, and passive investments such as bonds and shares, could qualify as free passive assets. In this respect, it should be noted that real estate – including rights

*“Earn-out and balance guarantee arrangements agreed upon in connection with the sale of a qualifying participation are also covered by the participation exemption.”*

over real estate – is not considered to be a free passive asset, unless the real estate is held by a Dutch exempt investment institution or a Dutch zero-taxed investment institution.

- The assets are intercompany receivables, unless they are used by an active group finance company or are financed entirely or almost entirely (90% or more) by third-party debt.
- The assets are leased to a group company, unless they are used by an active group leasing company or are 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 of low-taxed, free passive assets, all assets – excluding participations – of the company can be allocated to the participation as “good assets.”

Free passive assets of the participation qualify as “bad assets” only if they are considered to be low-taxed. This is generally the case if the income derived from these assets is not subject to a realistic levy according to Dutch tax standards. A similar approach to the Subject-to-Tax Test applies for this purpose.

### **Earn-Out and Balance Guarantee Arrangements**

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

### **Expiring Participation**

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

### **Non-Qualifying Participations**

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

### **Stock Options and Convertible Bonds**

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

## **Hybrid Loans and Profit Rights**

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

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

If a loan qualifies as a hybrid loan, the loan will be regarded as capital for corporation income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporation income tax purposes and, in principle, will be subject to a 15% dividend withholding tax.<sup>1</sup> On the other hand, the interest and principal received on a hybrid loan will be exempt from Dutch corporation income tax on the recipient and exempt from Dutch dividend withholding tax for the payer when the lender is a Dutch resident that owns a qualifying participation in the borrower or if the borrower qualifies as a related entity of the lender. See **Participation Exemption**.

The Anti-Tax Avoidance Directive within the E.U. restricts the benefits of the Parent-Subsidiary Directive (“P.S.D.”) where the participation exemption results in double nontaxation. The participation exemption is not applicable to payments or other forms of remuneration derived from a participation to the extent these payments can be deducted legally or *de facto*, directly or indirectly, from the 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 consider establishing a partitioning reserve with regard to the shares held. The purpose of this reserve is to determine the taxable or exempt amount of gains or losses, in order to avoid double taxation upon a realization of a gain or loss originating in the period prior to the formation of the partitioning reserve.

At the time of the transition from an exempt period to a taxable period, or vice versa, the participation must be adjusted from book value to fair market value. The result of the revaluation is included in the partitioning reserve. If the transition is from a taxable to an exempt sphere, a taxable partitioning reserve (“T.P.R.”) is formed. If the transition is 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).

<sup>1</sup> For further explanation regarding dividend withholding tax, see **Dividend Withholding Tax**.



## OTHER ASPECTS

### **Costs and Expenses**

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

### **Application of the at Arm's Length Principle**

Pursuant to Article 8bb of the C.I.T.A., the application of the arm's length principle is denied if it leads to a reduction of the taxable profit in the Netherlands. To illustrate the application of the provision, assume a Dutch borrower claims a deduction for arm's length interest on a loan even though no interest is paid. The deduction is denied to the extent that the creditor in another country does not include a corresponding amount of income in its tax base or includes a lesser amount than the deduction claimed in the Netherlands.

### **Base Erosion**

Limitations apply to interest deductions arising from transactions that could be considered to result in base erosion for Dutch tax purposes. Pursuant to Article 10a of the C.I.T.A., interest paid on loans from related entities and individuals is not deductible insofar as the loans relate to:

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

This rule prevents a Dutch taxpayer from deducting interest on loans to pay a dividend, to make an acquisition, or to make a contribution to capital. The base erosion provisions contain an exception under which 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; or
- The interest is subject to sufficient taxation in the hands of the recipient, and the recipient is not able to offset the interest income with losses from prior years or losses anticipated in the future, unless both the granting of the loan and the business transaction are not based on sound business reasons. Interest will be subject to sufficient taxation in the hands of the recipient if the recipient is taxed on profits determined under Dutch tax principles at a rate of at least 10%.

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

- The taxpayer holds at least one-third of the capital in the other entity.
- The other entity holds at least one-third of the capital of the taxpayer.

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

### **Earnings Stripping**

As of January 1, 2019, the Anti-Tax Avoidance Directive (“A.T.A.D. 1”)<sup>2</sup> was implemented in Dutch law through the introduction of Article 15b of the C.I.T.A. As a consequence, interest deductions will be limited to the highest of the following amounts:

- 20% of the company’s earnings before interest, taxes, depreciation and amortization (“E.B.I.T.D.A.”)
- An amount of €1 million (instead of the €3 million limit allowed by A.T.A.D. 1)

The Netherlands did not implement a group ratio escape rule. Moreover, Article 15b of the C.I.T.A. does not provide an exemption for financial businesses and stand-alone entities.

### **Hybrid Mismatches**

As of January 1, 2020, the amended Anti-Tax Avoidance Directive (“A.T.A.D. 2”) was implemented in Dutch law through the introduction of Article 12aa through 12ag of the C.I.T.A. Hybrid mismatches may occur in situations where countries use different qualifications for entities, financial instruments or permanent establishments.

The purpose of A.T.A.D. 2 is to neutralize the consequences of hybrid mismatches in affiliated relationships. The following anti-abuse rules apply:

- Payments made on a hybrid financial instrument will not be deductible in the event the corresponding income is not included in taxable income of the recipient within a reasonable period of time as a consequence of the hybridity of the instrument.
- Payments made to a hybrid entity will not be deductible to the extent they will not be taxed in the country where the hybrid entity is incorporated or established as a consequence of the hybridity of the entity.
- Payments made by a hybrid entity will not be deductible in the event the corresponding income is not included in taxable income of the recipient as a consequence of the hybridity of the payor.
- Payments made to an entity with one or more permanent establishments will not be deductible in the event the corresponding income is not included in taxable income because of a difference in allocation of these payments between head office and its permanent establishment or between two or more permanent establishments.

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<sup>2</sup> See also the relevant section of the chapter [“European Tax Law.”](#)

- Payments made to a disregarded permanent establishment will not be deductible to the extent they are not included in taxable income.
- Payments made will not be deductible to the extent they lead to a double deduction.

Article 12ab of the C.I.T.A. further stipulates that a payment received by a Dutch taxable entity will be included in taxable income of that entity, if (i) such payment would be exempt from Dutch corporation income tax or not be recognized as income as a consequence of a hybrid mismatch and (ii) such payment would be deductible for the payer.

Payments made by a Dutch entity to a foreign non-hybrid entity on a non-hybrid financial instrument will still not be deductible if the foreign entity uses the payments received to finance payments that would not be deductible on the basis of above rules, if made directly by the Dutch entity.

The Dutch taxpayer should have information in its permanent tax records showing that the A.T.A.D. 2 provisions are or are not applicable. In absence of such documentation, it will be presumed that the hybrid mismatch rules will apply, which implies that the burden of proof will shift to the taxpayer.

### **Controlled Foreign Corporations**

Article 13ab of the C.I.T.A. provides for the immediate taxation of passive income (less related expenses) generated by a foreign direct or indirect subsidiary established in a jurisdiction that

- levies a profit tax at a rate of less than 9%,<sup>3</sup> or
- is included on the E.U. list of noncooperative jurisdictions.<sup>4</sup>

The controlled foreign corporation (“C.F.C.”) rule is applicable to the foreign subsidiary in the above fact pattern, provided the Dutch holding company holds directly or indirectly an interest (i) representing more than 50% of the shares or the voting rights of the foreign subsidiary or (ii) that entitles the Dutch holding company to more than 50% of foreign entity’s profits, either directly or indirectly.

Passive income is defined as interest, royalties, dividends, and capital gains derived from shares, benefits derived from financial lease activities, benefits derived from insurance activities, banking activities or other financial activities, and benefits derived from certain re invoicing activities.

Immediate taxation on the basis of Article 13ab of the C.I.T.A. will not be imposed if (i) income other than passive income represents 70% or more of the income of the



<sup>3</sup> Included in the list of low-tax countries as of June 30, 2022, are Anguilla, the Bahamas, Bahrain, Barbados, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Turkmenistan, Turks and Caicos Islands, the United Arab Emirates, and Vanuatu. This list is updated annually based on an assessment as of October 1 of the preceding tax year.

<sup>4</sup> Included in the E.U. list of noncooperative countries as of June 30 2022, are American Samoa, the Cayman Islands, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, the U.S. Virgin Islands, and Vanuatu. This list is updated twice each year by the E.U.

foreign entity or (ii) the foreign entity is incorporated or established for valid business reasons that reflect the economic reality. Article 13ab of the C.I.T.A. does not apply if the passive income is repatriated from the C.F.C. to the direct or indirect Dutch holding company.

### **Innovation Box**

In order to stimulate research and development activities by Dutch taxpayers, self-developed registered patents and certain other assets for which a 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 as laid down in articles 12b through 12bg C.I.T.A. Pursuant to the Innovation Box regime, a 9% effective tax rate applies to income generated by a qualifying intangible, to the extent the income from the intangible exceeds the related R&D expenses, other charges, and amortization of the intangible. Income includes royalty income such as license fees and other income 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 9% effective tax rate will apply only to qualifying income. The non-qualifying income will continue to be subject to tax at the statutory rates in effect for the year.

The Innovation Box regime applies to income received from related and unrelated parties. The facility contains a threshold to prevent taxpayers from deducting expenses at the statutory rate while the corresponding earnings are taxed at the reduced effective rate of 9%. For this reason, the qualifying earnings should exceed the threshold before the effective tax rate of 9% 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. Consequently, the “nexus approach” has been introduced to the Dutch Innovation Box regime in order to determine what income is attributable to the innovation and thereby eligible for the reduced rate.

Other requirements to qualify for the Dutch Innovation Box regime include the following:

- 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,<sup>5</sup> or (ii) qualify as software.

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<sup>5</sup> Plant breeder’s rights are rights granted to the breeder of a new variety of plant that give the breeder exclusive control over the propagating material for the plant.

Finally, grandfathering rules apply up to July 1, 2021, for innovations that were produced before June 30, 2016, and that were already benefiting from the Innovation Box at that time.

### **Loss Compensation**

As of January 1, 2022, annual compensation for losses incurred during or after 2013 are limited to 50% of the taxable profit to the extent such profit exceeds a threshold of €1 million. This applies to both carryback and carry forward of losses. In addition, losses realized will be available to offset future taxable profits for an indefinite period. The carryback of losses is limited to one year.

### **Liquidation Losses**

As mentioned above, if the participation exemption applies, capital losses realized on, for example, the sale of a participation, are generally not deductible. An exception applies for losses arising as a consequence of the liquidation of a subsidiary. Such liquidation losses may be deductible under certain circumstances.

As of January 1, 2021, a liquidation loss exceeding €5 million will only be deductible if all of the following conditions are met:

- The subsidiary to be dissolved is established in the E.U. or the E.E.A.
- The Dutch corporate shareholder holds an interest in the subsidiary of more than 50% (formerly 5%), thereby providing a decisive influence on the subsidiary's activities.
- The liquidation is completed in the third year following the year in which the decision to liquidate was taken or the activities of the subsidiary were terminated (this restriction applies regardless of the amount of the liquidation loss).

### **Tax Treaty Network**

The Netherlands has a robust tax treaty network with more than 90 countries. The jurisdictions with which the Netherlands has a tax treaty currently in force as of April 1, 2022 are listed in the table below.

Albania	Egypt	Liechtenstein	Slovakia
Algeria	Estonia	Lithuania	Slovenia
Argentina	Ethiopia	Luxembourg	South Africa
Armenia	Finland	Macedonia	South Korea
Aruba	France	Malawi	Spain
Australia	Georgia	Malaysia	Sri Lanka
Austria	Germany	Malta	St. Martin
Azerbaijan	Ghana	Mexico	Suriname
B.E.S. Islands	Greece	Moldova	Sweden
Bahrain	Hong Kong	Montenegro	Switzerland
Bangladesh	Hungary	Morocco	Taiwan
Barbados	Iceland	New Zealand	Thailand
Belarus	India	Nigeria	Tunisia



Belgium	Indonesia	Norway	Turkey
Bermuda	Ireland	Oman	Uganda
Bosnia & Herzegovina	Israel	Pakistan	Ukraine
Brazil	Italy	Panama	U.A.E.
Bulgaria	Japan	Philippines	U.K.
Canada	Jordan	Poland	U.S.A.
China	Kazakhstan	Portugal	Uzbekistan
Croatia	Kosovo	Qatar	Venezuela
Curaçao	Kuwait	Romania	Vietnam
Czech Republic	Kyrgyzstan	Saudi Arabia	Zambia
Denmark	Latvia	Singapore	Zimbabwe

### **Multilateral Instrument**

As part of the B.E.P.S. Project, the Multilateral Instrument (“M.L.I.”) was introduced. The M.L.I. aims to prevent international tax avoidance and improve coordination between tax authorities. For further background please see the chapter on European Tax Law. The Netherlands became a signatory to the M.L.I. in June 2017 and the M.L.I. was ratified by Dutch Parliament in March 2019. The instrument of ratification was deposited with the O.E.C.D. shortly after. A reservation to Article 12 of the M.L.I. was made by the Netherlands in regard to the artificial avoidance of permanent establishment status. Depending on when the instruments of ratification were deposited by other countries, the M.L.I. was effective for the dividends provision as of January 1, 2020, and for the other provisions of the treaty by January 1, 2021, for most treaties.

## **TAX RULINGS**

On July 1, 2019, the Dutch Ministry of Finance introduced its new tax ruling practice for rulings with an international character. Reasons for updating the international tax ruling practice are (a) to ensure that tax rulings will only be granted, if the relevant taxpayer has sufficient economic nexus with the Netherlands and (b) to improve overall transparency of the Dutch tax ruling practice.

A taxpayer will be deemed to have sufficient economic nexus if (i) it forms part of a group that carries on commercial, operating activities in the Netherlands, (ii) the commercial, operating activities are performed for the account and risk of the taxpayer for which sufficient personnel is available at group level in the Netherlands, and (iii) the commercial, operating activities fit with the function of the taxpayer within the group.

An international tax ruling will not be issued when (a) saving Dutch or foreign taxes is the sole or decisive reason for the actions and transactions to be covered in the tax ruling or (b) the subject of the tax ruling primarily relates to the tax consequences of direct transactions with companies that are resident in a low-tax jurisdiction<sup>6</sup> or an E.U. black-listed jurisdiction.<sup>7</sup>

<sup>6</sup> See *supra* note 4 for low tax countries in 2022.

<sup>7</sup> See *supra* note 5 for blacklisted countries.



It is therefore possible that a ruling request will be denied even though the economic nexus requirements are met.

An international tax ruling can be issued for the following topics:

- Application of the participation exemption
- Qualification of hybrid financial instruments and hybrid entities
- Application of C.F.C. provisions
- The presence or absence of a permanent establishment of a foreign entity in the Netherlands
- The extra-territorial taxation of foreign shareholders of a Dutch holding company
- Exemption from Dutch dividend withholding tax
- Advance pricing agreements

In order to enhance transparency regarding the tax ruling process, an anonymous summary of the tax ruling will be published on the website of the Dutch Ministry of Finance. The summary contains a brief explanation of the facts and circumstances, as well as the main conclusions derived from transfer pricing reports or other documentation, on which the ruling is based. A summary will also be published when the tax ruling was denied or retracted including the reasons for the denial.

When filing an international tax ruling request, the taxpayer can indicate the taxable period covered by the tax ruling. In general, a tax ruling will be valid for a maximum of five years. If the facts and circumstances justify an exception, as in the case of long-term contracts, a maximum period of ten years may be applied, but a mid-term review is required.

The tax ruling will be laid down in a settlement agreement between the Dutch tax authorities and the taxpayer. The settlement agreement will contain (a) the critical assumptions on which the tax ruling is based and (b) an acknowledgment that the settlement agreement will be terminated immediately if there are changes in relevant tax laws.

## 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%. Since January 1, 2018, distributions of profits to a qualifying member<sup>8</sup> by a Dutch cooperative used as a holding vehicle are also subject to Dutch dividend withholding tax. The rate may be reduced under an applicable 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

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<sup>8</sup> A qualifying member is a member that is entitled to at least 5% of the annual profits or the liquidation proceeds of the Dutch cooperative.

levied over incoming dividends that cannot be claimed as a credit by the holding company by virtue of the participation exemption.

No dividend withholding tax is levied on dividends paid by a Dutch-resident entity to nonresident corporate shareholders, if all the following conditions exist:

- The corporate shareholder is a tax resident of a country within the E.U. or E.E.A., or a country with which the Netherlands has concluded a tax treaty containing a provision covering dividends.
- The Dutch participation exemption, which in principle requires a minimum shareholding of 5%, would have been applicable to the shareholding in the Dutch entity distributing the dividends had the recipient of the dividends been a resident of the Netherlands.
- The corporate shareholder does not fulfill a similar function as a Dutch exempt investment institution or Dutch zero-taxed investment institution.
- The corporate shareholder is the beneficial owner of the dividends.

Under an anti-abuse rule, the dividend withholding exemption at source does not apply if (a) the main purpose, or one of the main purposes, for which the foreign shareholder holds its interest in the Dutch entity is to avoid Dutch dividend withholding tax (a subjective test) and (b) the structure or transaction is considered artificial and not set up for valid business reasons (an objective test).

A structure or transaction is considered artificial if and to the extent it was not put into place for valid business reasons that reflect economic reality. Valid business reasons 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-level holding company that carries out material management, policy, and financial functions for the group it heads, or (iii) functions as an intermediate holding company performing a linking function within the group structure in relation to the relevant Dutch target. An intermediate holding company can only perform a linking function if its direct or indirect corporate shareholder and its direct or indirect subsidiary or subsidiaries each conduct a material business enterprise.

In the case of an intermediate holding company, the company must also meet the following minimum substance requirements:

- At least half of the managing directors reside or are established in the state in which the intermediate holding company is tax resident.
- The resident managing directors of the intermediate holding company have sufficient professional knowledge to perform their duties.
- The intermediate holding company has personnel qualified for the proper execution and registration of the planned transaction.
- All management board meetings are held in the resident state of the intermediate holding company and are in principle attended by all board members.
- All decisions of the management board are made and executed in the resident state of the intermediate holding company.

***“A structure or transaction is considered artificial if and to the extent it was not put into place for valid business reasons that reflect economic reality.”***

- The bank account(s) of the company are managed and maintained in or from the resident state of the intermediate holding company.
- The resident managing directors should be solely authorized to approve all transactions on the company's main bank accounts.
- The bookkeeping of the company is done in the resident state of the intermediate holding company.
- The company's address is in the resident state of the intermediate holding company.
- The company is not considered to be resident of another country.
- The company runs real risks with respect to its financing, licensing, or leasing activities.
- The company finances its participations with a minimum of 15% equity.
- The company must incur €100,000 in salary expenses for competent, not merely supporting, staff.
- The company has a fully equipped office space at its disposal for at least 24 months.

On February 26, 2019, the E.U. Court of Justice (“E.C.J.”) rendered a decision on the definition of ‘tax avoidance’ in the context of the substance requirements and beneficial ownership in the so-called “Danish Cases.”

The court ruled that E.U. Member States are obliged to deny the application of exemptions from tax – such as the dividend withholding tax exemption – to a recipient of income that is a “conduit company,” because such conduit company cannot be considered the beneficial owner of income. Whether a specific recipient of a dividend is a beneficial owner or merely a conduit company, is a factual question and the facts of each case must be analyzed to reach a conclusion.

As a result of the Danish Cases, the Dutch C.I.T.A. was changed as of January 1, 2020, giving the Dutch tax authority the opportunity to demonstrate that a structure is abusive, even if the relevant substance criteria are satisfied. Consequently, the substance requirements no longer serve as a safe haven preventing imposition of Dutch dividend withholding tax. The substance criteria function as mere indicators for the non-abusive character of a specific fact pattern.

If, based on the above-mentioned anti-abuse provisions, the dividend withholding tax exemption is not applicable, the provisions of an applicable tax treaty may still be available, at least in principle. It should be noted however that with respect to the dividend provision of a tax treaty as of January 1, 2020, and with respect to other provisions as of January 1, 2021, the P.P.T. of the M.L.I. applies to most of the tax treaties concluded by the Netherlands. This suggests that protection under the tax treaty will not be available where the principal purpose of setting up the intermediary holding company was to obtain a tax treaty benefit.



## PROPOSED EXIT TAX

A legislative proposal was submitted to parliament by one of its members introducing an exit tax in the Dutch dividend withholding tax act for certain cross-border reorganizations. If enacted, the proposal would have a retroactive effect from December 8, 2021 at 9:00 A.M.

The primary reason for introducing the proposal was to create a deterrent for listed companies such as Unilever and Royal Dutch Shell to move their residence abroad and specifically to the U.K.

The proposed exit tax applies to both (i) a transfer of the place of effective management to a qualifying state, not being an E.U. Member State and (ii) cross-border mergers, demergers, or share-for-share mergers. A qualifying state is a jurisdiction that (a) does not levy a withholding tax on dividends similar to the Dutch dividend withholding tax or (b) allows for a step-up to fair market value upon an international reorganization for purposes of its dividend withholding tax.

If a Dutch company transfers, merges, or demerges to a qualifying state within this context, the Dutch company will be deemed to have distributed all of its profit reserves to its shareholders immediately prior to its emigration, insofar the profit reserves exceed €50 million. Unlike the previous proposal, the collection of the tax cannot be postponed.

As stated above, the proposal is primarily aimed at listed companies, because Dutch holding companies currently owned by a corporate shareholder in a jurisdiction with which the Netherlands has concluded a tax treaty will generally be protected against the exit tax pursuant to that tax treaty.

The proposal is under discussion with the Second Chamber of Parliament. It is currently not clear whether there will be a political majority in support of the proposal. Hence, the likelihood of enactment is unknown.

## CONDITIONAL WITHHOLDING TAX

One of the attractions of the Netherlands is that in principle no withholding tax is levied over outgoing interest and royalty payments. However, in order to combat international tax avoidance and to prevent the Netherlands from being used as a gateway for interest and royalty payments to low-tax jurisdictions, a conditional withholding tax (in Dutch, “*bronbelasting*”) on interest and royalty payments to affiliated entities located in low-tax jurisdictions, came into effect on January 1, 2021. The rate of withholding tax is equal to the highest rate of corporation income tax applicable at that point in time (25.8% in 2022).

The conditional withholding tax applies only to payments to affiliated entities. An entity is deemed to be affiliated if (a) the recipient company has a qualifying interest in the paying company, (b) the paying company has a qualifying interest in the recipient company, or (c) a third company has a qualifying interest in the recipient company and the paying entity.

An interest in a company is considered a qualifying interest if the recipient company directly or indirectly maintains a decision-making influence at the level of the paying company. This is the case where the recipient company can exercise more than

50% of the voting rights of the paying company. Furthermore, companies can be affiliated, if they are part of a cooperating group that jointly have a qualifying interest in the paying company.

Low-tax jurisdictions are jurisdictions with a statutory corporation income tax rate of less than 9%<sup>9</sup> and jurisdictions that are included on the E.U. list of noncooperative jurisdictions.<sup>10</sup> Insofar the low-tax jurisdiction is a jurisdiction with which the Netherlands has concluded a tax treaty, this jurisdiction will not be deemed to be a low-tax jurisdiction until three calendar years have passed from the time the jurisdiction is listed in a ministerial decree or included on the E.U. list of noncooperative jurisdictions. The aim of the three-year period is to give tax treaty partners time to renegotiate the existing tax treaty.

In addition to direct interest and royalty payments to entities in low-tax jurisdictions, the conditional withholding tax in principle applies to the following payments:

- Payments to a foreign affiliated company that is not a resident of a low-tax jurisdiction, but has a permanent establishment in a low-tax jurisdiction to which the payment should be allocated.
- Payments to a foreign affiliated company that is not a resident of a low-tax jurisdiction but is considered transparent for Dutch tax purposes and non-transparent in the state where the shareholders of the foreign affiliated company reside (*i.e.*, a hybrid company).
- Payments to a foreign affiliated company that is not a resident of a low-tax jurisdiction but is considered non-transparent for Dutch tax purposes and transparent in the state of its residence and its shareholders are residing in a low-tax jurisdiction (*i.e.*, a hybrid company), unless the paying company or the recipient company proves that each of the ultimate beneficiaries with a direct qualifying interest in the hybrid company (or by means of a cooperating group) meets the following conditions:
  - The ultimate beneficiary owner is deemed to be the owner of the interest income in its country of residence.
  - The ultimate beneficiary would not have been subject to the conditional withholding tax without the interposition of the hybrid company.

In certain abusive situations, the conditional withholding tax also applies to interest and royalty payments to a foreign affiliated company that is not a resident in a low-tax jurisdiction. This is the case if there is an artificial arrangement or series of arrangements and an entity in the jurisdiction that is not a low-tax jurisdiction is interposed with the main purpose, or one of the main purposes, being the avoidance of the conditional withholding tax.

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<sup>9</sup> See *supra* note 4 for a list of low tax jurisdictions.

<sup>10</sup> See *supra* note 5 for a list of low tax jurisdictions.

## EXTRA-TERRITORIAL TAXATION AND ANTI-ABUSE RULES

In addition to dividend withholding tax levied on dividends distributed, a nonresident corporate shareholder of a Dutch holding entity may be subject to Dutch corporation income tax on the dividends or capital gains derived from its shareholding, if 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, or one of the main purposes being, to avoid the levy of Dutch income tax with respect to another person.
- There is an artificial arrangement or series of artificial arrangements similar to the artificial structure or transactions described above in **Dividend Withholding Tax**.

Dutch corporation income tax will be levied at a rate of 15.0% for the first €395,000 and 25.8% for the excess (2022 rates). Any dividend withholding tax levied can be offset against the corporation income tax due.

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

## CAPITAL TAX AND STAMP DUTIES

The Netherlands does not levy any kind of capital tax, stamp duties, or other registration charges with respect to the issuance or transfer of shares in a Dutch-resident company except for real estate transfer tax (“R.E.T.T.”) in certain circumstances. R.E.T.T. is levied if a purchaser acquires real estate or at least one-third of the shares of a “real estate company.” A company is considered a real estate company if more than 50% of its assets consist – or consisted one year prior to its acquisition – of real estate used for passive investment and at least 30% of its assets consist of Dutch real estate. R.E.T.T. is levied on the fair market value of real estate located in the Netherlands, with the consideration paid as a minimum. The general R.E.T.T. rate was increased from 6.0% to 8.0% as of January 1, 2021 and is proposed to be increased to 10.1% as of January 1, 2023. For residential real estate bought by individuals for their own long-term accommodation a reduced rate of 2% applies.

First-time buyers on the housing market between the ages of 18 and 34 years who are acquiring residential real estate with a maximum acquisition price of €400,000 are eligible for a R.E.T.T. exemption. The maximum acquisition price will increase to €440,000 as of January 1, 2023. The first-time buyer can use the exemption only once.

## COVID-19

The Dutch government introduced a number of economic and tax measures aimed at mitigating the economic effects of the COVID-19 pandemic. The tax measures include, *inter alia*,

- a deferral of payment of corporate income tax, personal income tax, wage tax, and V.A.T.;
- a reduction of the rates of collection interest (*invorderingsrente*) and tax interest (*belastingrente*);
- an accelerated carryback of losses expected to be incurred in 2020 as a consequence of the COVID-19 pandemic;
- the rules and regulations applicable to “frontier workers” from Belgium and Germany will be applied as if they worked in the Netherlands consistently during the COVID-19 pandemic; and
- when enforcing the substance requirements under Dutch tax laws and regulations, the travel restrictions caused by the COVID-19 pandemic will be taken into consideration.

***“The Dutch government introduced a number of economic and tax measures aimed at mitigating the economic effects of the COVID-19 pandemic.”***



## IRELAND

### Author

James Somerville  
A & L Goodbody  
Dublin

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

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

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

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

The author acknowledges the contribution of his colleagues Darragh Noone and Cian Ryan, also of A&L Goodbody, in updating this chapter of the article.

## RECENT DEVELOPMENTS

### Update on Ireland's International Tax Strategy

In tandem with Finance Act 2020, the Irish government published an update in January 2019 on continuing progress in modifying the Irish international tax strategy. Ireland was one of the first ten jurisdictions to be evaluated for the second time under the new terms of reference by the O.E.C.D. Global Forum on Transparency and Exchange of Information for Tax Purposes, achieving the top rating of "Compliant." Ireland has ratified the B.E.P.S. Multilateral Instrument ("M.L.I.") and has demonstrated continued commitment to the global automatic exchange of information. Ireland has implemented the third, fourth, fifth and sixth revisions of the Directive on Administrative Cooperation ("D.A.C."). The sixth iteration of D.A.C. requires tax advisors and companies to disclose any tax planning arrangements that meet certain hallmarks indicative of aggressive tax planning. Ireland has been supportive of such measures and was one of only three E.U. Member States to have pre-existing mandatory disclosure rules in place. Ireland has been actively engaged in the O.E.C.D. B.E.P.S. Project and the work of the Tax Force on the Digital Economy, and has also transposed anti-hybrid rules into its domestic legislation under the E.U.-Anti-Tax Avoidance Directives ("A.T.A.D."). On October 7, 2021, Irish Minister

for Finance Paschal Donohoe confirmed that Ireland would sign up for the O.E.C.D. International Tax Agreement on Pillars One and Two.

### **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 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 was as follows:

- **Action Item 1 (Digital Economy):** No special action is needed as of yet as the O.E.C.D. concluded ring-fenced solutions are not appropriate.
- **Action Item 2 (Hybrid Mismatches):** Ireland's new anti-hybrid rules came into force January 1, 2020, transposing the first and most substantive part of the A.T.A.D. 2 anti-hybrid rules. Rules regarding reverse hybrids came into effect January 1, 2022.
- **Action Item 3 (Controlled Foreign Corporation Rules):** Controlled foreign corporation ("C.F.C.") rules were introduced January 1, 2019. Ireland has opted for Option B in determining the attribution of income of a C.F.C. to its parent.
- **Action Item 4 (Interest Deductions):** While originally of the view that national laws were equally effective to the A.T.A.D. interest limitation rule, Ireland introduced the interest limitation rule under Finance Act 2021, taking effect for accounting periods commencing on or after January 1, 2022.
- **Action Item 5 (Harmful Tax Practices):** As a pre-emptive action, Ireland moved to phase out the so-called "double Irish" tax structure in 2014 and introduced its own O.E.C.D.-compliant patent tax regime (the "Knowledge Development Box" or "K.D.B.") in 2015. The K.D.B. was the first such incentive to be recognized as being fully compliant with the rules agreed upon during the B.E.P.S. initiative.

- **Action Item 6 (Treaty Abuse):** Over time, measures to protect against treaty abuse should become part of Ireland's treaties. Ireland's pre-existing G.A.A.R. meets the required standard under A.T.A.D.
- **Actions Items 8, 9, and 10 (Transfer Pricing):** Ireland has followed Recommendation 6 of the Review of Ireland's Corporate Tax Code, acknowledging that it should provide for the application of the O.E.C.D. 2017 Transfer Pricing Guidelines incorporating B.E.P.S. Actions 8, 9, and 10 in Irish legislation. Ireland has revised its transfer pricing rules to incorporate these Guidelines. The new rules are effective for accounting periods beginning on or after January 1, 2020.
- **Action Item 13 (C.b.C. Reporting):** Ireland signed the O.E.C.D.'s multilateral competent authority agreement in January 2016 and separately introduced Country-by-Country Reporting legislation in Finance Act 2015.
- **Action Item 15 (Multilateral Instrument):** Ireland played its part in the negotiations leading to the adoption of the Multilateral Instrument on November 24-25, 2016. Ireland was one of the first countries to sign the M.L.I. in June 2017 and deposited its instrument of ratification with the O.E.C.D. on January 29, 2019, meaning the Multilateral Instrument came into force in Ireland on May 1, 2019.

#### **F.A.T.C.A.**

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

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

#### **C.R.S.**

Ireland is a signatory jurisdiction to the Multilateral Competent Authority Agreement on Automatic Exchange of Finance Account Information, which was entered into by Ireland in its capacity as a signatory to the Convention on Mutual Administrative Assistance on Tax Matters. Ireland has introduced legislation to implement the O.E.C.D.'s common reporting standard ("C.R.S.") internationally and to implement Directive 2014/107/E.U. on Administrative Cooperation in the field of Taxation ("D.A.C. 2") with respect to the exchange of information between E.U. Member States. The C.R.S. has been effective in Ireland since January 1, 2016, and the deadline for first reporting to the Irish tax authorities was June 30, 2017.

*"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."*

## **State Aid Investigation**

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

### **European Commission Decision Regarding Apple and Ireland**

The Commission published its much-anticipated decision on the *Apple* case on December 19, 2016, against which both Apple and the Irish government have lodged appeals with the Court of Justice of the European Union. The E.U. General Court (“E.G.C.”) heard oral arguments from both Ireland and Apple in September 2019. The Department of Finance conducted negotiations with Apple over setting up a holding account for the €13 billion the Commission says is due to Ireland in back taxes, pending the outcome of the appeals. Although in October 2017, the Commission indicated it was taking Ireland to the E.C.J. over delays in recovering the money, Apple deposited €13.1 billion plus €1.2 billion in interest into an escrow account set up by the Irish government.

While the appeals process is ongoing – and several years are expected to pass before a conclusion is reached – the money will remain in escrow and will be invested in a managed account in order to maintain its value. Notably, the total amount of aid payable has since been reduced to account for taxes paid to other countries, following approval granted by the Irish Minister of Finance to reduce same on an annual basis.

### **Annulment by E.G.C. of the Decision of the European Commission**

In a decision announced on July 15, 2020, the E.G.C. annulled the decision taken by the Commission regarding the Irish tax rulings, and held in favor of Apple. In the view of the E.G.C., the European Commission did not succeed in showing to the requisite legal standard that there was an advantage for the purposes of Article 107(1) T.F.E.U.

In the press release announcing the decision, the E.G.C. endorsed the Commission’s approach to normal taxation under the Irish tax law, using the tools developed within the O.E.C.D., such as the arm’s length principle. These tools may be applied in order to check whether the level of taxable profits endorsed by the Irish tax authorities corresponds to that which would have been obtained under market conditions.

However, the E.G.C. considered that the Commission erred in its primary line of reasoning. Under the approach adopted by the Commission, all the income arising from the Apple Group intellectual property licenses held by A.S.I. and A.O.E. should have been taxed in Ireland as income from Irish-based operations. To support that approach, the Commission should have demonstrated the value of the activities actually carried out by the Irish branches themselves. That demonstration was not undertaken and the E.G.C. could not ignore the strategic decisions taken and implemented outside of those branches.



In addition, the E.G.C. concluded that the Commission did not succeed in demonstrating the existence of methodological errors in the Irish tax rulings which led inappropriately to a reduction in ASI and AOE's taxable profits in Ireland. The defects identified by the Commission were not, in themselves, sufficient to prove the existence of an advantage for the purposes of Article 107(1) T.F.E.U.

The Commission lodged an appeal before the E.C.J. against the decision of the E.G.C. on September 25, 2020. The primary ground of appeal relates to the rejection by the E.G.C. of the Commission's primary line of reasoning as to the existence of a tax advantage. The Commission in its appeal asserts that the E.G.C. failed to have regard to the analysis contained in the Commission's decision as to the functions performed by the head offices and Irish branches to justify the allocation of the Apple IP licenses to the Irish branches. The Commission also asserts that the E.G.C. contravened the separate entity approach and the arm's length principle by incorrectly relying on functions carried out by Apple Inc. in order to reject the allocation of I.P. to the Irish branches, as well as by finding that acts of the directors of A.S.I. and A.O.E. constitute functions performed by their head offices.

### **A.T.A.D.**

#### **A.T.A.D. 1**

The Anti-Tax Avoidance Directive ("A.T.A.D.") was adopted as Council Directive 2016/1164/E.U. on July 12, 2016, and had to be implemented by all E.U. Member States by January 1, 2019. Among the measures in A.T.A.D. is an interest limitation rule ("I.L.R.") which closely follows the provisions of B.E.P.S. Action 4. The I.L.R. was introduced in Ireland under Finance Act 2021, and takes effect for accounting periods commencing on or after 1 January 2022. The effect of the I.L.R. is to reduce the maximum tax deduction allowed for net borrowing costs to 30% of the taxpayer's E.B.I.T.D.A. However, there are a number of exclusions from the I.L.R., for example, legacy debt where the terms were agreed prior to June 17, 2016, and have not changed, as well as there being a *de minimis* threshold, under which the I.L.R. will not apply if an Irish interest group has net interest costs of less than €3 million.

#### **A.T.A.D. 2**

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. Ireland has transposed the rules with effect from January 1, 2020, except for the reverse hybrid rule which took effect as of January 1, 2022. This brings domestic law into line with 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. Ireland strongly supported the quick adoption of A.T.A.D. 2.

## **CORPORATE TAX RATE**

The Irish rate of corporate tax on trading income is 12.5%. The word "trading" is not defined in the legislation, but instead, reliance is placed on Irish and U.K. case law. The substantial volume of U.K. case law on this point is not binding upon Irish courts

but is of persuasive value, depending on the seniority of the U.K. court. Broadly speaking, it is unlikely that the income of a pure holding company would qualify as trading income. The income is more likely to be characterized as passive income, as it will be composed of dividends, interest, and royalties from its subsidiaries.

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

Under the O.E.C.D. Pillar Two framework, it is proposed that a 15% global minimum level of taxation will be introduced in the coming years, and the European Commission has proposed a draft directive to implement these rules consistently across E.U. Member States. This would have the effect of increasing Ireland's corporation tax rate to 15% in respect of large groups that meet the annual threshold of at least €750 million of consolidated revenue in at least two of the four preceding years. However, the Irish government has pledged to retain the existing 12.5% rate of corporation tax for all other trading entities. On June 18, 2022, unanimous support for the measure failed as Hungary announced its opposition.

## DIVIDENDS RECEIVED BY IRISH COMPANIES

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

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

Foreign dividends are subject to Irish tax at the rate of either 12.5% or 25%. The 12.5% rate applies to dividends paid out of trading profits by a company that (i) is resident in an E.U. Member State or treaty country or a country that has ratified the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters, (ii) has issued shares that are substantially and regularly traded on a stock exchange in an E.U. Member State, a treaty partner country of Ireland, or a country that has ratified the O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters, and (iii) is a 75%-owned subsidiary of a company described in clause (ii).

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<sup>1</sup> Ireland has signed double taxation treaties with 76 countries, 73 of which are in effect.

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

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

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

## DIVIDENDS PAID BY IRISH HOLDING COMPANIES

When profits are extracted by way of dividends or other distributions from other European holding companies, difficulties can sometimes arise in relation to dividend withholding tax in the holding company jurisdiction. While dividends and other distributions made by an Irish holding company may be subject to Irish withholding tax, currently imposed at the rate of 25%, a number of exceptions exist under domestic law that make the withholding tax less problematic in Ireland than in many other European holding company jurisdictions. Typically, an Irish holding company that is controlled directly or indirectly by persons resident in an E.U. Member State or a treaty country should not suffer any withholding tax on dividend payments.

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

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

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



control of a person that is resident in an E.U. Member State (other than Ireland) or in a treaty country.<sup>2</sup>

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

There is no requirement for nonresident companies receiving dividends from Irish resident companies to provide tax residence and/or auditor certificates in order to obtain exemption from dividend withholding tax. Instead, a self-assessment system 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.

*“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.”*

## EXEMPTION FROM CAPITAL GAINS TAX ON THE SALE OF FOREIGN SHARES

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

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

<sup>2</sup> Where there is a chain of ownership, the exemption does not apply if an Irish-resident company is in the chain.



the investee company and its subsidiaries, taken as a whole, consist wholly or mainly of trading.

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

## FINANCING THE IRISH HOLDING COMPANY – INTEREST PAYMENT DEDUCTIONS

The A.T.A.D. interest limitation rules were introduced in Ireland under Finance Act 2021, and took effect for accounting periods commencing on or after January 1, 2022. Prior to these rules, an Irish holding company could be financed principally by way of debt, as an Irish tax deduction was potentially available for interest on monies borrowed to finance the acquisition of shares. As discussed in **A.T.A.D.1** above, the effect of the I.L.R. is to reduce the maximum tax deduction allowed for net borrowing costs to 30% of the taxpayer's E.B.I.T.D.A., though a number of exclusions exist in respect of legacy debt and where the interest group has net interest costs of less than €3 million.

Interest is allowed as a deduction if the underlying indebtedness is used in acquiring any part of the ordinary share capital of any of the following companies:

- A trading company
- A company whose income consists mainly of real estate rental income
- A direct holding company of a company referred to above
- A company whose business consists wholly or mainly of holding stocks, shares, or securities of a company that is a trading company indirectly through an intermediate holding company or companies
- A company whose business consists wholly or mainly of the holding of stocks, shares, or securities directly in a company whose income consists mainly of real estate rental income

A deduction is also allowed for interest on funds borrowed, if the funds are used wholly and exclusively for the purposes of the borrower's trade or business, or that of a company connected with it.

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



In addition, anti-avoidance measures restrict the deductibility of interest where (i) intra-group borrowings are used to finance the acquisition of group assets or (ii) relief is claimed by way of an interest expense deduction on a borrowing to fund activities of related foreign companies. In such circumstances, the interest expense deduction may be denied where the relevant foreign income generated by the use of the loan proceeds is not remitted to Ireland.

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

## FINANCING OF THE IRISH HOLDING COMPANY – INTEREST WITHHOLDING TAX

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

## TREATY NETWORK

Ireland has signed double taxation agreements with 76 jurisdictions, listed below, 73 of which are currently in effect (*i.e.*, excluding Ghana, Kenya and Kosovo).

Albania	Ethiopia	Lithuania	Saudi Arabia
Armenia	Finland	Luxembourg	Serbia
Australia	France	Macedonia	Singapore
Austria	Georgia	Malaysia	Slovakia
Bahrain	Germany	Malta	Slovenia
Belarus	Ghana	Mexico	South Africa
Belgium	Greece	Moldova	South Korea
Bosnia & Herzegovina	Hong Kong	Montenegro	Spain
Botswana	Hungary	Morocco	Sweden
Bulgaria	Iceland	Netherlands	Switzerland

Canada	India	New Zealand	Thailand
Chile	Israel	Norway	Turkey
China	Italy	Pakistan	Ukraine
Croatia	Japan	Panama	U.A.E.
Cyprus	Kazakhstan	Poland	U.K.
Czech Republic	Kenya	Portugal	U.S.A.
Denmark	Kosovo	Qatar	Uzbekistan
Egypt	Kuwait	Romania	Vietnam
Estonia	Latvia	Russia	Zambia

Irish-resident companies are taxable on their worldwide income. The treaties avoid double taxation by providing for a credit for foreign tax imposed, whether directly or indirectly, on the income received by the Irish company. The credit is allowable only against the Irish tax on the same income. Notably, Irish domestic law grants a tax treatment more favorable than that given by the treaties.<sup>3</sup>

## CAPITAL DUTY

Capital duty is not imposed on a company with regard to share capital and certain other transactions.

## STAMP DUTY ON SHARES

Stamp duty of 1% of the value is imposed on the transfer of shares in an Irish company, except transfers listed on the Enterprise Securities Market of the Irish Stock Exchange. 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).

<sup>3</sup>

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

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

Pursuant to FA 2018, Ireland introduced controlled foreign corporation (“C.F.C.”) rules. The rules apply for accounting periods beginning on or after January 1, 2019. C.F.C. rules are an anti-abuse measure targeted at the diversion of profits to offshore entities in low or no tax jurisdictions. The basic premise of C.F.C. rules is to attribute certain undistributed income of the offshore entity to its controlling parent and taxing same. Broadly, an entity will be a C.F.C. where it is (i) subject to more than 50% control by a parent company and its associated enterprises and (ii) tax on its profits account for less than half the tax that would have been paid had the income been taxed in the parent company’s country of tax residence.

The C.F.C. regime applies to Irish tax on income of foreign resident companies where certain activities are performed in Ireland by a company that controls the C.F.C.

A.T.A.D. allows Member States to determine whether the income of a C.F.C. should be attributed to its parent using one of two options. Ireland has opted for option B. Option B attributes undistributed income arising from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage. It focuses on bringing the income that is artificially diverted from Ireland to a low tax jurisdiction back into the Irish tax net.

There are a number of exclusions from the scope of the C.F.C. charge. For example, the C.F.C. charge does not apply where securing a tax advantage was not the essential purpose of the arrangement giving rise to the C.F.C.’s income or where the C.F.C. has profits of less than €75,000 or low value activities. With effect from accounting periods beginning on or after January 1, 2021, certain of these exclusions will not apply for an accounting period of a C.F.C. that is resident in a noncooperative jurisdiction.

Apart from the recharacterization rules under which interest may be treated as a dividend, and certain anti-avoidance provisions restricting interest deductibility in certain intra-group debt scenarios, Ireland does not have thin capitalization rules.

## TRANSFER PRICING

In 2019, Ireland revised its transfer pricing rules to bring the rules in line with the 2017 O.E.C.D. Transfer Pricing Guidelines (the “2017 Guidelines”). The new rules take effect for accounting periods beginning on or after January 1, 2020 and provide that arm’s length nature of a price will be determined in accordance with the 2017 Guidelines. In addition, the changes mean that Irish transfer pricing rules now apply to certain non-trading transactions, certain larger capital transactions and to previously grandfathered transactions that were agreed prior to July 1, 2010. A further revision, introduced under Finance Act 2021 and applying to chargeable periods commencing on or after January 1, 2022, provides further detail as to the domestic non-trading transactions excluded from the scope of the Irish transfer pricing rules, and makes it clear that there does not need to be any consideration in order for the exemption to apply.

*“In 2019, Ireland revised its transfer pricing rules to bring the rules in line with the 2017 O.E.C.D. Transfer Pricing Guidelines.”*

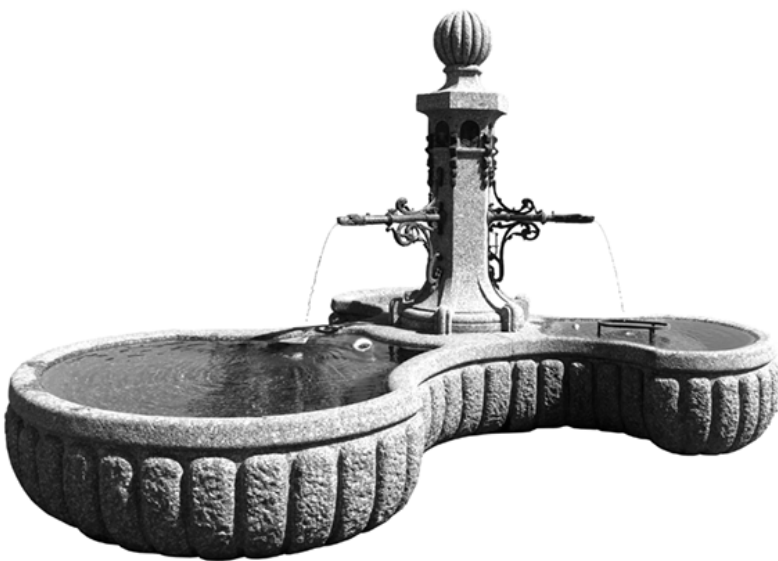
Subject to the execution of a Ministerial Order, Irish transfer pricing rules will also apply to transactions involving small and medium enterprises (“S.M.E.’s”). The change also brings in enhanced Irish transfer pricing documentation requirements in line with the 2017 Guidelines. Importantly, the rules also grant the Irish Revenue Commissioners the power to invoke a substance-over-form provision to disregard and recharacterize a transaction in certain circumstances.

## RELEVANT ANTI-AVOIDANCE PROVISIONS

Ireland has had a general anti-avoidance rule since 1989 but does not have any specific holding company anti-avoidance provisions.

## CONCLUSION

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



## SPAIN

### Author

Guillermo Canalejo Lasarte  
Uría Menéndez  
Madrid

### INTRODUCTION

A Spanish holding company, or “*entidad de tenencia de valores extranjeros*” (familiarily known by its Spanish acronym “E.T.V.E.”), is an ordinary Spanish company subject to 25% tax on its income. In relation to E.T.V.E.’s, as of January 1, 2021, the full exemption with respect to dividends and capital gains obtained from its subsidiaries has been reduced to a 95% exemption. In practice, this means that dividends and capital gains obtained by Spanish C.I.T. taxpayers, including E.T.V.E.’s,<sup>1</sup> would be taxed at an effective 1.25% tax rate (25% C.I.T. rate on the 5% of the registered dividends/capital gains).<sup>2</sup>

In addition to these standard features of a holding company, the E.T.V.E. regime offers a substantial advantage in relation to other attractive European holding company locations, as dividends funded from income earned from qualified foreign subsidiaries and distributed by the E.T.V.E. to non-Spanish resident shareholders are made free of Spanish withholding tax, unless the shareholder is resident in a tax haven or noncooperative jurisdiction. This is subject to an anti-abuse rule discussed in **Exemption of E.T.V.E. Dividend Distributions**, regarding certain back-to-back dividends. In addition, capital gains triggered by a nonresident shareholder upon the transfer of an interest in an E.T.V.E. are not subject to Spain’s 19% capital gains tax if the capital gains indirectly arise from an increase in value of the qualified foreign subsidiaries of the E.T.V.E., unless the shareholder is resident in a tax haven or noncooperative jurisdiction.

Subject to the Anti-Tax Avoidance Directive (“A.T.A.D.”) of the E.U., E.T.V.E.’s are protected by E.U. directives such as the Parent-Subsidiary Directive (“P.S.D.”) and the Merger Directive, and are regarded as Spanish residents for tax purposes under Spain’s 95 bilateral tax treaties currently in force.

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<sup>1</sup> Either tax resident in Common Territory or the Basque Country or Navarra.

<sup>2</sup> The participation exemption regime will only apply in cases where the equity stake represents at least 5% in the relevant subsidiaries. The acquisition value of at least €20 million in cases where the minimum stake is not fulfilled will no longer be available for fiscal years starting on or after January 1, 2026 – after a five-year transitory regime applicable to subsidiaries held prior to January 1, 2021.

## INCOME TAX TREATIES

Listed below are the jurisdictions that have income tax treaties with Spain that are currently in force:

Albania	Czech Republic	Kyrgyzstan	Senegal
Algeria	Dominican Republic	Latvia	Serbia
Andorra	Ecuador	Lithuania	Singapore
Argentina	Egypt	Luxembourg	Slovakia
Armenia	El Salvador	Macedonia	Slovenia
Australia	Estonia	Malaysia	South Africa
Austria	Finland	Malta	South Korea
Azerbaijan	France	Mexico	Sweden
Barbados	Georgia	Moldova	Switzerland
Belarus	Germany	Morocco	Tajikistan
Belgium	Greece	Netherlands	Thailand
Bolivia	Hong Kong	New Zealand	Trinidad & Tobago
Bosnia & Herzegovina	Hungary	Nigeria	Tunisia
Brazil	Iceland	Norway	Turkey
Bulgaria	India	Oman	Ukraine
Canada	Indonesia	Pakistan	U.A.E.
Cape Verde	Iran	Panama	U.K.
Chile	Ireland	Philippines	U.S.A.
China	Israel	Poland	Uruguay
Colombia	Italy	Portugal	Uzbekistan
Costa Rica	Jamaica	Qatar	Venezuela
Croatia	Japan	Romania	Vietnam
Cuba	Kazakhstan	Russia	
Cyprus	Kuwait	Saudi Arabia	

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

Spain has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("M.L.I."). At the time of signing, Spain submitted a list of 86 tax treaties entered into by Spain and designated as Covered Tax Agreements ("C.T.A.'s"), *i.e.*, tax treaties to be amended through the M.L.I. Together with the list of C.T.A.'s, Spain also submitted a provisional list of reservations and notifications ("M.L.I. Positions") regarding various provisions of the M.L.I. The definitive M.L.I. Positions were provided with the deposit of Spain's instrument of ratification, acceptance, or approval of the M.L.I.

On September 28, 2021, Spain deposited its instrument of ratification of the M.L.I. (signed June 7, 2017), and it came into force on January 1, 2022. The provisions of the M.L.I. with respect to C.T.A.'s will come into effect after both Spain and the



other party to the relevant C.T.A. have deposited instruments of ratification, acceptance, or approval of the M.L.I. and the specified time for the relevant provisions has passed.

## EXEMPTION ON QUALIFIED DOMESTIC AND FOREIGN-SOURCE INCOME

The main tax feature of the E.T.V.E. is that both dividends obtained from qualified domestic and nonresident subsidiaries and capital gains realized on the transfer of the shares held by the E.T.V.E. in qualified domestic and nonresident subsidiaries are 95% exempt from Spanish corporation income tax (“C.I.T.”).

The 95% exemption applies subject to the fulfillment of specific requirements governing both the investments made by the E.T.V.E. and the E.T.V.E. itself. In general, the effective 1.25% tax cost is not eliminated for dividends distributed within a Spanish C.I.T. group. Nonetheless, the limitation on the participation exemption regime does not apply to dividends when the following circumstances occur cumulatively:

- The entity distributing the dividend was incorporated on or after January 1, 2021.
- Dividends are received in the first three years following the year of incorporation of the entity making the distribution.
- The entity receiving the dividend meets all of the following requirements:
  - Its net revenue in the previous period does not exceed €40 million.
  - It is not considered a passive-asset-holding company (*entidad patrimonial*).
  - It does not form part of a group of companies in accordance with Article 42 of the Spanish Commercial Code prior to the incorporation of the entity making the distribution.
  - It does not hold a significant stake in another company prior to the incorporation of the entity that distributes the dividend.

## QUALIFIED DOMESTIC AND FOREIGN INVESTMENTS

According to Articles 108 and 21 of the C.I.T. Law, dividends and capital gains received by an E.T.V.E. from domestic and nonresident subsidiaries are 95% exempt from Spanish taxation if the following requirements are met:

- The E.T.V.E. directly or indirectly holds a minimum 5% stake in the equity of the subsidiary (and any second-tier subsidiary).
- The E.T.V.E. directly or indirectly holds the minimum stake in the subsidiary and any second level subsidiary for at least one year, which in the case of dividends may be completed thereafter.





*“The E.T.V.E. must hold the stake in the subsidiary, whether directly or indirectly, 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 minimum 10% nominal income tax rate. In applying this test, it does not matter that an exemption, deduction, or other tax advantage applies to reduce the effective tax rate. Alternatively, the test is met if the foreign subsidiary benefits from an income tax treaty entered into by its country of residence and Spain, provided that it is not resident in a tax haven country or noncooperative jurisdiction.<sup>3</sup>

### **Minimum Stake and Holding Period**

The 5% stake requirement must be met by the E.T.V.E. on the direct and indirect holding of any subsidiary. In certain circumstances, if a direct or indirect subsidiary obtains more than 70% of its income from dividends, rights to share in profits, or the transfer of shares in other entities, the E.T.V.E. must indirectly hold at least 5% of the share capital in all lower-tier subsidiaries.<sup>4</sup>

The E.T.V.E. must hold the stake in the subsidiary, whether directly or indirectly, for at least one year.<sup>5</sup> In the case of dividends, this minimum holding period requirement need not be met on the day dividends are distributed. Rather the one-year period can be completed after the distribution date. However, Spanish tentative tax will be levied upon receipt of the distribution, and a refund can be claimed when the one-year holding period has been fulfilled. In the case of capital gains, the minimum stake and minimum holding period requirements must be fulfilled on the date the capital gain transaction takes place.

### **Subject to and Not Exempt from Tax**

Nonresident subsidiaries must be subject to and not exempt from a tax of a nature similar to Spanish C.I.T., with a nominal tax rate of at least 10%, regardless of the application of any exemption, reduction, deduction, or other tax advantage.

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

<sup>3</sup> Significant changes to the Spanish list of tax haven jurisdictions have been introduced to align with O.E.C.D. and E.U. guidelines and, as a result of such amendment, from July 11, 2021, the term tax haven was replaced by “*noncooperative jurisdiction*.” The “noncooperative jurisdiction” concept expands the previous notion of a tax haven to include not only states and territories, but also preferential tax regimes. Until the new Spanish Ministry Order is issued (for which no date has been set), the current Spanish tax haven list will remain in force.

<sup>4</sup> For instance, companies within the same group that submit consolidated financial statements, or cases in which dividends or profits have been subject to taxation without being entitled to the exemption or double-taxation deduction, are excluded from complying with this requirement.

<sup>5</sup> For the purpose of calculating this period, the period in which the shares have been held by other entities within the same group, under the meaning of Article 42 of the Spanish Commercial Code, shall also be taken into account.

of information clause. The Spanish General Directorate of Taxation (“G.D.T.”) has recognized that the minimum taxation requirement operates automatically.

Finally, nonresident subsidiaries located in one of the following tax havens or nonco-operative jurisdictions as established by Royal Decree 1080/1991 and Law 36/2006 of 29 November, as applicable do not qualify for the E.T.V.E. tax exemption regime:

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

A company formed in any of the foregoing jurisdictions may allow a Spanish stakeholder to benefit from the E.T.V.E. regime in either of two fact patterns. The first is that a nonresident subsidiary is resident in a Member State of the European Union and the E.T.V.E. can demonstrate to the Spanish tax authorities that (i) the incorporation and operations of the nonresident subsidiary are carried out for valid economic reasons and (ii) the nonresident subsidiary is engaged in economic activities. The second is that the relevant country or territory has entered into an exchange of information treaty with Spain or has entered into a tax treaty with Spain that contains an exchange of information clause. If either such treaty has been entered into, the country or territory will immediately cease to be considered a tax haven or noncooperative jurisdiction, unless such country is added to the list by decision of the Spanish tax authorities.

### **Economic Activity Carried Out by the Nonresident Subsidiary**

In addition to the above requirements, the exemption for capital gains arising from the transfer of shares is conditional on the finding that the nonresident subsidiary carried out an economic activity and was not a holding company for passive assets (*entidad patrimonial*), an Economic Interest Group, or an entity for which the Spanish C.F.C. regime applies for Spanish resident shareholders. For this purpose, according to Article 5.2 of the C.I.T, a subsidiary is considered a passive-asset holding company if more than 50% of its assets are securities or the company is not engaged in a business activity. Under C.I.T. Law, a company’s business activity is defined as the organization on its own account of material and human resources for the purposes of taking part in the supply of goods and services.

The Spanish C.F.C. regime is applicable where two conditions are met. The first is that the Spanish resident shareholder’s stake in the subsidiary exceeds 50% of the share capital, equity, profits, or voting rights of the company. The second is that the income of the nonresident entity is taxed under a regime that is identical or similar in nature to the Spanish C.I.T. at a rate that is less than 75% of the Spanish C.I.T. rate.

## QUALIFIED HOLDING COMPANY

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

- Its corporate purpose must include the management and administration of nonresident entities. The E.T.V.E. may also carry out activities in Spain or in other jurisdictions in addition to the management and administration of nonresident entities, but those activities will not be covered by the E.T.V.E. regime.
- It must have sufficient material and human resources to manage the company. The G.D.T. has also repeatedly stated that an E.T.V.E. has an appropriate level of material and human resources when at least one of the members of the board of directors of the Spanish-resident company is in charge of the day-to-day management of the E.T.V.E. This condition is met if the director is responsible for preparing and keeping the E.T.V.E.'s accounts, preparing and filing periodic tax returns, bank account movements, issuing payment orders for both running costs (salaries, notary, and registration fees, etc.) and particular disbursements (additional investments of funds in subsidiaries, orders for distribution of dividends to shareholders, etc.).
- The securities that represent its share capital must be nominative.
- It must inform the Spanish authorities that it has opted to be subject to the provisions of the Spanish E.T.V.E. regime. The tax regime will apply to the first tax period ending after the notification is received and all successive periods until notice of termination is given to the Spanish tax authorities.

## DEDUCTION OF COSTS

The value of a stake in nonresident subsidiaries may be recorded for accounting and tax purposes under the general C.I.T. rules applicable to all Spanish-resident companies. Financing expenses connected with the participation are tax deductible within the limits on the deduction of financial expenses, as explained in **Corporation Income Tax** regarding the interest barrier rule.

## CAPITAL LOSSES

A capital loss realized upon the transfer of the shares of a domestic or nonresident subsidiary is not deductible where (i) the requirements set out in **Qualified Domestic and Foreign Investments** above are met or (ii) the nonresident subsidiary is neither a resident of a tax treaty jurisdiction nor subject to a nominal income tax rate of at least 10%. Exceptions are provided for losses that arise as a result of the liquidation or termination of the subsidiary in a transaction that is not part of an internal corporate restructuring.

## LIQUIDATION LOSSES

Subject to certain limitations, a loss realized upon the liquidation of a nonresident subsidiary is deductible, unless it is liquidated as a result of an internal restructuring transaction. In that case, capital losses are reduced in the amount of the dividends



received from the nonresident subsidiary during the 10-year period that precedes the dissolution date, provided that such dividends (i) have not reduced the acquisition value of the equity participation and (ii) qualified for an exemption or deduction regime.

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

Dividends distributed by an E.T.V.E. to nonresident shareholders out of qualified exempt income (*i.e.*, dividends and capital gains that were exempt from tax at the level of the E.T.V.E.) will not be subject to Spanish withholding tax unless the shareholder is resident in a tax haven or noncooperative jurisdiction. Dividends distributed by an E.T.V.E. out of non-exempt income will be subject to the standard 19% withholding tax or the reduced bilateral tax treaty rate, as applicable.

Note that dividends paid by an E.T.V.E. to its E.U.-resident shareholder or to shareholders with residence in the European Economic Area (“E.E.A.”) will be exempt from Spanish withholding tax, provided the shareholder meets all the following conditions:

- It takes one of the forms set out in the Annex to the P.S.D.
- It is subject to, and not exempt from, tax as listed in Article 2(c) of the P.S.D.
- The dividend distribution does not proceed from the liquidation of the E.T.V.E.
- It owns directly at least 5% of the share capital of the E.T.V.E.
- It has held the stake for at least one year immediately preceding the dividend payment, or continues to hold the participation until the one-year period is completed.<sup>6</sup>

Certain anti-abuse rules may apply when the stake in the E.U.-resident shareholder is mainly held, directly or indirectly, by persons who are not tax resident in an E.U. Member State or E.E.A. Member State. Here, again, an exception may apply if the incorporation and operations of the shareholder are justified by valid economic motives and substantive business reasons.

In addition, several binding rulings issued by the Spanish tax authorities have held that exempt income earned through an E.T.V.E.’s foreign permanent establishment are properly treated as qualified exempt income of the E.T.V.E. when distributed in the form of dividends to a nonresident shareholder or realized as capital gains by a nonresident shareholder. Hence, such dividends and gains would not be taxed in Spain when received or realized by a nonresident shareholder.

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

Capital gains realized by nonresident shareholders on the disposal of Spanish shares are normally subject to a 19% tax. However, several exemptions may be

<sup>6</sup> In the latter case, a tentative withholding tax will be levied upon distribution and the E.U.-resident shareholder will be entitled to claim a refund once the one-year holding period has elapsed.

available to nonresident shareholders on gains resulting from the disposal of shares in an E.T.V.E.

The first exemption is provided under domestic Spanish law. As long as the shareholder is not resident in a tax haven or noncooperative jurisdiction, capital gains realized by nonresident shareholders from the disposition of shares of an E.T.V.E. will not be subject to the Spanish capital gains tax to the extent that the capital gains are equivalent to (i) the existing reserves from qualified foreign-source exempt income of the Spanish holding company or (ii) the appreciation in value of its stake in foreign subsidiaries and the stake fulfills the requirements described above during the entire holding period.

The second exemption is provided under relevant income tax treaties. Capital gains on the disposal of shares in an E.T.V.E. will generally not be subject to Spanish taxation if an applicable income tax treaty provides for an exemption.

The third exemption relates to rules under Spanish domestic law that are enjoyed by E.U.- and E.E.A.-resident shareholders. The exemption applies if the following conditions are met:

- The E.T.V.E.'s assets do not mainly consist, directly or indirectly, of Spanish real estate.<sup>7</sup>
- If the E.U. or E.E.A. transferor is an individual, the equity interest in the E.T.V.E. amounts to less than 25% of total equity at all times during the 12-month period preceding the disposal of the interest.
- If the E.U. or E.E.A. resident is an entity, the participation exemption requirements set out in Article 21 of the C.I.T. Law must be met with respect to the E.T.V.E.
- The gain is not obtained through a country or territory defined as a tax haven under applicable Spanish regulations or a noncooperative jurisdiction, as discussed above.

## LIQUIDATION OF E.T.V.E.

The liquidation of an E.T.V.E. triggers recognition of capital gains not subject to withholding tax, but taxable, if at all, as described above in **Capital Gains on Transfer of E.T.V.E.** A liquidation will also trigger capital duty unless specific or special provisions apply. This is discussed below in **Corporation Income Tax.**

## OTHER INCOME TAX ISSUES

In recent years, the Spanish tax authorities have challenged tax deductions for interest expense claimed by Spanish-resident corporate taxpayers that participate

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<sup>7</sup> This exception does not apply when the disposing shareholder is a Spanish resident corporation subject to C.I.T. In that context, the different tax treatment applicable to investments in Spanish property-rich companies by Spanish-resident entities and entities resident in a E.U./E.E.A. Member State should be deemed an unjustified infringement of the E.U. principle of free movement of capital and freedom of establishment.

in intragroup transactions involving the purchase of shares of one member of the group, from another member of the group, in a transaction that is funded by a loan from a third member of the group. The basic claim in those cases is that the intra-group transaction is tax abusive because it lacks a business purpose.

In 2012, the Spanish Parliament ring-fenced the use of these potentially abusive schemes by enacting Royal Decree-Law 12/2012, amending the C.I.T. Law. For C.I.T. purposes, the Decree prohibits deductions for interest expenses on 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. Nevertheless, the Royal Decree-Law states in its preamble that a group restructuring that is a direct consequence of an acquisition by third parties and that could include specific debt push downs and situations in which the acquired companies are in fact managed from Spain can be deemed reasonable from an economic perspective. The preamble is silent when the acquired companies are managed outside Spain.

## CORPORATION INCOME TAX

### Rate

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

For tax periods beginning on or after January 1, 2022, the Spanish government released the General State Budget Bill for fiscal year 2022. It introduced a minimum 15% C.I.T. rate over the taxable base for taxpayers (i) with a net turnover of at least €20 million in the preceding 12 months or (ii) that are taxed under the C.I.T. consolidation regime, regardless of their net turnover amount.

### Interest Barrier Rule

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

In addition, Law 27/2014 of November 27, 2014, introduced new limits on interest expense deductions arising from leveraged buyouts. The deduction is limited to 30% of the acquiring company's E.B.I.T.D.A. or €1.0 million, if greater. When computing the E.B.I.T.D.A. base, E.B.I.T.D.A. is ignored when attributable to any company that merges with the acquiring company or joins the same tax group as the acquiring company within the four-year period following the acquisition. This limitation does not apply when the acquisition loan represents not more than 70%

*“An E.T.V.E. is subject to the 25% C.I.T. on income other than qualified dividends and capital gains.”*

of the acquisition price and the principal of the loan is amortized fully over an eight-year period in equal installments.

### **Other Nondeductible Expenses**

Impairment allowances for share capital or equity investments in companies are generally not deductible under the C.I.T. However, impairment is deductible at the time of a transfer or disposal of the participation, provided the following requirements are met during the prior year:

- The participation is less than 5% of the total investment in the impaired company.
- In the case of participation in the capital of nonresident entities, the subsidiary (i) has been 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 in effect an income 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 for the current year. The payments must be made by the 20th day of April, October, and December.

Typically, an E.T.V.E. would not be required to make a tax payment to the extent its income qualifies for the participation exemption. However, as a consequence of an amendment made in October 2016,<sup>8</sup> C.I.T. taxpayers with net turnover of €10 million or more, including dividends and capital, in the 12-month period preceding the first day of the tax period are obliged to make a minimum payment equivalent to 23% of the accounting result computed without taking into account tax exemptions or tax credits.<sup>9</sup>

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

### **Capital Duty**

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

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

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<sup>8</sup> Royal Decree Law 2/2016 of September 30, introducing tax measures intended to reduce the public deficit.

<sup>9</sup> The conformity of this amendment and minimum payment with constitutional principles is questionable.

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

### **Transfer Pricing**

According to the C.I.T. Law, Spanish companies are required to enter transactions with related parties, as defined in Article 18.2 of the C.I.T. Law, on an arm's length basis. In accordance with the O.E.C.D. Guidelines, the comparable uncontrolled price method, the cost-plus method, the resale price method, the profit split method, or the transactional net margin method may be used to determine the arm's length value of a controlled transaction, with no preference given to any of the listed methods.

Additionally, the parties must produce and maintain appropriate documentation to demonstrate the basis for the valuation used. This obligation is not applicable for certain entities and transactions that fulfill specified requirements, which principally include the following cases:

- Transactions carried out between companies forming part of a tax consolidation group
- Transactions that an Economic Interest Group or Temporary Joint Venture ("U.T.E.") carries out with its members or with other entities belonging to the same tax consolidation group. However, transactions with foreign permanent establishments are subject to documentation requirements
- Transactions carried out in the context of a takeover bid or a public stock offering
- Transactions with the same related individual or entity when the total market value does not exceed €250



The tax authorities are entitled to impose transfer pricing penalties for noncompliance in two situations. The first is when the taxpayer does not comply with its documentation obligations. The second is when the taxpayer complies with the documentation obligations, but the value of the transaction used by the taxpayer differs from the documentation provided to the authorities. Thus, if the valuation used in controlled transactions with related parties is consistent with the documentation provided to the authorities, even if the tax authorities disagree with the resulting valuation, no penalties will be imposed.

For the taxable year beginning on January 1, 2016, Country-by-Country ("C.b.C.") reporting is required for operations of multinational groups based in Spain. These reporting requirements will apply also to a Spanish company that is a member of a foreign-based group when (i) its nonresident parent company is not required to file a C.b.C. report in its country of tax residence and (ii) the foreign-based group has a consolidated annual turnover exceeding €750 million. Spanish entities have an obligation to file C.b.C. reports within 12 months following the last date of the tax year.

Additionally, Spanish resident entities belonging to a group that is required to file C.b.C. reports must notify the Spanish tax authorities prior to the close of the taxable year.



The C.I.T. Law allows a Spanish resident company to apply for a unilateral advance pricing agreement or “A.P.A.” The Spanish C.I.T. regulations detail the procedure for evaluating A.P.A.’s submitted to the tax authorities. Taxpayers must submit detailed documentation together with specific proposals, depending on the type of A.P.A.

With respect to international transactions, the regulations allow for an application requesting a bilateral advanced pricing agreement (“B.A.P.A.”) between the Spanish tax authorities, the tax authorities of the other country, the Spanish taxpayer, and its foreign affiliate.

Spanish tax authorities encourage taxpayers to submit A.P.A. proposals and recent experience is that they are flexible when evaluating proposals.

### **Controlled Foreign Corporations**

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

- i. financial income;
- ii. dividends;
- iii. passive real estate income;
- iv. royalties;
- v. sales and services provided to a related party in which the foreign entity or foreign permanent establishment adds little or no economic value;
- vi. insurance;
- vii. leasing financial activities; and
- viii. other financial activities, regardless of whether the recipient is a Spanish tax resident.

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

An E.T.V.E. is not required to recognize tainted income obtained by its E.U. and E.E.A. affiliates to the extent that the E.T.V.E. can demonstrate to the Spanish tax authorities that the E.U. or E.E.A. affiliate is engaged in an active trade or business.

### **B.E.P.S.**

The C.I.T. Law that entered into force for tax periods beginning in 2015 introduced certain B.E.P.S.-inspired measures, mainly seeking to address hybrid instruments and payments. In particular, these measures are as follows:

- Interest on 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.
- Dividends received from foreign subsidiaries will not be entitled to the participation exemption to the extent that the dividend distribution has triggered a tax-deductible expense in the foreign subsidiary.

### **Transposition of the A.T.A.D. II (Hybrid Mismatches)**

For tax periods starting as of January 1, 2021, expenses incurred in cross-border transactions may not be tax deductible when part of a plan is designed to achieve a double no-taxation or double deduction tax result arising from differences existing between Spain and another jurisdiction (“hybrid mismatches”) in the legal characterization of a transaction.

### **The European Commission’s Directive Proposal on Fighting the Use of Shell Entities and Arrangements for Tax Purposes**

On December 22, 2021, the European Commission published proposal 2021/0434, which lays down rules for preventing the misuse of so-called shell entities for tax purposes and amends Directive 2011/16/EU (“Unshell Directive”).

Shell entities are companies and other entities which do not have substance and have minimal or no economic activity. They may be created and used for the sole purpose of obtaining tax advantages and attempting to avoid or evade taxes.

The main objective of the Unshell Directive is to prevent the misuse of shell entities for tax purposes by establishing criteria to identify entities that present a risk of not complying with minimum levels of economic substance – *i.e.*, a “substance test.” It also creates a reporting obligation for taxpayers and establishes negative tax consequences for entities considered to be shell entities.

The legislative procedure for the Unshell Directive remains ongoing and the provisions will be subject to additional discussion and potential amendments. According to the current version, Member States will have to transpose the Directive into their national laws by June 30, 2023, and the Directive will enter into force on January 1, 2024.



## PORTUGAL

**Author**  
João Luís Araújo  
TELLES  
Porto

Having gone through a very difficult economic period after the global financial crisis that started in 2007, Portugal has become an attractive, investment destination for foreign investors and individuals.

Introduced in 2012, the non-habitual tax resident regime regularly brings to Portugal wealthy individuals, foreign companies, and the executives of those companies.

At more or less the same time, Portugal implemented a comprehensive set of tax reforms and other measures that were aimed at easing the way of doing business and making the country more attractive for investment:

- Corporate income tax reform was introduced in 2014 (Law No. 2/2014, of January 16).
- A new tax and legal framework were adopted in 2015 regarding collective investment vehicles (Decree-Law No. 7/2015, of 13 January).
- The concept of Real Estate Investment Trusts (Decree-Law No. 19/2019, of 28 January 2019) were introduced.

Portugal's efforts in attracting investment have focused on the creation of business-friendly environment that is designed to promote innovation and entrepreneurship. To that end, Portugal has emerged as an important platform for investment in the E.U. and in the Portuguese-speaking markets of Brazil, Angola, and Mozambique.

To that end, the following should be highlighted:

- The participation exemption regime
- The patent box
- Tax credits on R.&D. expenditure
- Tax credits on certain qualifying investment expenditure
- The tax consolidation regime
- Tax deductions following certain capitalizations of companies
- Tax exemption or refunds for acquisitions of properties that are to be rehabilitated
- A reduced V.A.T. rate on property rehabilitations
- Special tax regimes applicable to certain investment vehicles, notably

- real estate investment vehicles,
- collective investment vehicles in movable assets, and
- venture capital funds.

In this context, it is important to note that under proposed legislation that should be effective from January 1, 2023, the Portuguese patent box regime will become even more attractive. In simplified terms, the current regime foresees that only 50% of the profits on income related to the exploration or disposal of patents, industrial designs, or software is subject to corporate income tax. If the proposed legislation is enacted, only 15% of the profit will be subject to tax.

The updated patent box, together with the S.I.F.I.D.E. tax credits (one of the benefits on R&D expenditure available) and the financial incentives regime relating to R&D investments, make Portugal one of the most attractive countries in the world from which to carry out R&D activities.

In sum, Portugal has been implementing a competitive tax system and a business-friendly environment that features a variety of legal forms and fund regimes that are suitable for holding, financing, and investing in securities and real estate.

## CORPORATE INCOME TAX SYSTEM

### Overview

Portugal has enacted a typical corporate income tax system that follows E.U. Directives.

Resident companies and nonresident companies maintaining a permanent establishment (“P.E.”) in Portugal are subject to a corporate income tax called “*Imposto sobre o Rendimento das Pessoas Coletivas*,” or “I.R.C.” and a state surcharge (“*derrama estadual*”). Regarding resident companies, the I.R.C. is levied on worldwide income, including capital gains, as set forth in Articles 4 and 87-A of the Corporate Income Tax Code (“C.I.R.C.”). Municipalities may also levy a municipal surcharge (“*derrama municipal*”) on the annual taxable income of corporations.

A company is deemed resident in Portugal when having its legal seat or place of effective management in Portugal. For this purpose, Portugal consists of mainland Portugal, the archipelagos of the Azores and Madeira, the respective territorial sea, and any area which, under international law, is under Portuguese jurisdiction.

The standard corporate tax rate (“I.R.C.”) rate is 21%. As mentioned, a state surcharge may apply at the following progressive tax rates:

- 3% on income over €1.5 million
- 5% on income over €7.5 million
- 9% on income over €35 million

The law caps the municipal surcharge at a maximum rate of 1.5%, although exemption or lower rates may be available depending on the specific rules of each municipality.

I.R.C. is charged on net tax taxable income, consisting of business/trading income, passive income, and capital gains. Generally speaking, only realized income and capital gains and losses are relevant for the computation of taxable income, although there are certain exceptions to this rule (namely related to financial instruments accounted for at fair market value). A foreign tax credit for the tax paid abroad is usually available.

The C.I.R.C. also provides for a simplified tax regime for companies with taxable income of up to €200,000. Here, the taxable income simply is a percentage of the annual turnover, with the percentage varying based on the type of business that is conducted.

### **Deductible Expenses; Interest Limitation Rule**

As a general rule, duly documented expenses are tax deductible to the extent incurred for the purpose of the carrying on of the business activity.

Regarding interest expense deductions, Portugal imposes an interest expense limitation rule. The rule has been amended with the transposition of the Anti-Tax Avoidance Directive (“A.T.A.D.”) adopted by the European Commission (“the Commission”).

Companies may only deduct net interest expenses up to the higher of

- €1 million, and
- 30% of E.B.I.T.D.A. concept.

This interest limitation rule applies to Portuguese tax resident companies and non-resident companies that maintain a P.E. in Portugal. Interest expenses that exceed the limit are not deductible, but may be carried forward and claimed as a deduction in the following five fiscal years if available limitation exists in any of the carryforward years.

The law provides several exclusions from the interest deduction limitation rule. The exclusion covers companies subject to the supervision of the Portuguese Central Bank or the Portuguese Insurance and Pension Fund Supervisory Authority. Also covered are Portuguese branches of other E.U. financial companies or insurance companies that are resident in a Member State of the E.U.

Securitization vehicles are also excluded from the interest limitation rule. However, in May 2020, the Commission notified Portugal that the exclusion for securitization companies does not qualify as “financial vehicles” under the A.T.A.D. Given that securitization vehicles are subject to strict regulation in Portugal and are under the supervision of the Portuguese Securities and Market Exchange Commission, the position of the Commission came as a surprise.

### **Permanent Establishments**

A fixed place of business in Portugal through which the business of a non-resident entity is wholly or partly carried on may trigger permanent establishment (“P.E.”) concerns in Portugal. The C.I.R.C. includes within the concept of P.E. the following standard examples of a physical premises through which business is carried on:



- A place of management
- A branch
- An office
- A factory
- A workshop
- A fixed installation in Portugal, which is broadly interpreted to include a building site, construction, assembly or installation project or supervisory activity connected to the installation
- Deep water platforms and vessels for the exploration of natural resources are included when the site, project, or activities last for more than six months

Since 2021, specifications have also been in place on the consideration of a dependent agent P.E. and the inclusion of the service P.E. concept which is not usually seen among the tax treaties entered by Portugal.

### **Group Consolidation**

A group consolidation regime<sup>1</sup> is available to affiliated companies when the parent company is a Portuguese tax resident or is a tax resident in another E.U. Member State. For group consolidation to apply, there must be a dominant company holding, directly or indirectly, at least 75% of the share capital of the subsidiaries and that holding must allow the dominant company to own at least 50% of the voting rights in the subsidiaries.

Once that hurdle is met, certain additional criteria must also be met:

- All group companies are subject to tax and effectively managed in Portugal.
- The dominant company must hold the participation in the subsidiaries at least one year prior to the application of the regime.
- The dominant company cannot be controlled by another company which fulfills the criteria to be a dominant company.
- The application of the regime has not been waived by the dominant company in any of the last three years prior to the (eventual new) application of the group consolidation.

Where group consolidation applies, the tax group is not a taxpayer. Rather, each of the companies within the group remain autonomous taxpayers. Transactions between group companies are not disregarded for tax purposes. However, the taxable income of the group derives from the aggregation of the taxable income of all the group companies, allowing losses in one company to set-off income of another company of the group.

Any tax losses incurred by a group member company prior to entering the group are ringfenced and are available to set-off the taxable income of that company only.

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<sup>1</sup> Called “*Regime Especial de Tributação de Grupos de Sociedades*,” R.E.T.G.S., which is provided in Articles 69 *et. seq.* of the C.I.R.C.

The group consolidation allows the interest expense limitation rules to be applied on a groupwide basis. Once group E.B.I.T.D.A. is determined, the cap applies to the aggregate interest expense of all members of the group.

### **Tax Neutrality Regime: Reorganizations / M&A**

The Portuguese C.I.R.C. provides for certain tax-free reorganizations under the tax neutrality regime. The Portuguese tax neutrality regime essentially mirrors the E.U. Merger Directive providing rollover relief for qualifying mergers, demergers, partial demergers and share-for-share exchanges of resident companies or companies resident in an E.U. Member State.

As is the case in other E.U. countries, the tax neutrality regime works by establishing that the acquisition date and the cost basis of the transferred shares or assets must be carried over to the new holding. The transaction remains tax neutral even if cash payments are made to shareholders, provided that the cash amount does not exceed 10% of the nominal value of the transferred shares.

### **Standalone Taxation**

The Portuguese C.I.T. provides for standalone taxation on certain expenses, such as: unduly or undocumented expenses, general representation and entertainment expenses, mileage and *per diem* allowances, and payments made to residents in tax haven jurisdictions unless evidence exists that the payment relates to a genuine business expense and the amount is not unusual nor excessive.

The amount is self-assessed and due even if no standard I.R.C. amount is payable.

### **Rulings**

The tax authorities usually provide general official rulings with their view and interpretation of specific provisions of a tax statute.

Taxpayers can also apply for an advanced ruling. In these rulings, the tax authorities issue their position regarding a particular situation, transaction or operation under a description of facts presented by the taxpayer. Such rulings are binding on the tax authorities only with regard to taxpayer making the request and to the particular set of facts presented. They are not binding in matters related to other taxpayers or other sets of facts.

Advanced rulings are usually available for public consultation on an anonymous and factually sanitized basis. As in other countries, they provide useful guidance regarding the views of the tax authority may take on similar transactions, even if the ruling is not binding on the tax authorities in matters pertaining to other taxpayers.

Finally, the law also provides for the possibility of advanced transfer pricing agreements.

### **Tax Arbitration**

Portuguese tax disputes are resolved in fairly complex legal proceedings with final resolution by the courts achieved only after many years of litigation. Settlement of the issue by agreement of the parties is not common as is the case in other European countries.

In 2011, the government recognized the failings of the traditional dispute resolution mechanisms and introduced arbitration in tax matters. Tax arbitration and its legal regime were implemented by means of Decree-Law No. 10/2011, of 20 January, the *Regime Jurídico de Arbitragem Tributária* (“R.J.A.T.”), having the specific purpose of promoting faster resolution of tax disputes and reducing the backlog of pending tax cases in Portuguese courts. The Portuguese tax authorities are subject and bound by the decisions issued by tax arbitration panels (called tax arbitration courts or “*Tribunais Arbitrais*”) regarding disputes up to €10,000,000. Also, if a taxpayer chooses the tax arbitration route, the tax authorities need to accept this decision and cannot try and move the case to regular courts.

Tax arbitration has been implemented with great success and is usually highly regarded by taxpayers and legal professionals due to its efficiency and the quality of the arbitral decisions. Decisions should be issued in six months, with the possibility of an extension of an additional six-month period. Consequently, a final decision may be reached on a given tax dispute in less than one year. There is no requirement that arbitrators must be judges or former judges. The arbitrators may be former judges, but they also may be professors, authors, lawyers, tax consultants, economists, or former senior members of the tax authority. To be eligible to be an arbitrator, an individual must have at least ten years of effective experience in tax matters and must be “of proven technical ability, having high moral standards and sense of public interest.”

In disputes up to €60,000, the tax arbitration courts work with a single arbitrator unless the taxpayer opts to appoint an arbitrator. Where that occurs, the tax authorities may also appoint an arbitrator, with a third arbitrator acting as chair and being chosen by the Administrative Arbitration Center (“*Centro de Arbitragem Administrativa*” or “C.A.A.D.”). In disputes above €60,000, the arbitration courts must consist of a panel of three arbitrators who are appointed by the C.A.A.D. unless the taxpayer elects to appoint one of the arbitrators. In that case, the tax authority appoints a second arbitrator and the C.A.A.D. appoints the third arbitrator who serves as chair.

Once tax arbitration is elected, the opportunities to appeal from an adverse decision are restricted. Consequently, the decision to move to tax arbitration should not be taken lightly but should be evaluated and reviewed carefully beforehand.

## PARTICIPATION EXEMPTION – RESIDENT HOLDING COMPANIES

Portugal does not have in place a specific holding companies regime. Nonetheless, the law provides for a participation exemption regime which was introduced by the 2014 corporate income taxation reform.

Under the participation regime, dividends received from qualified resident and non-resident subsidiaries and capital gains realized from the transfer of a participation in qualified resident and nonresident subsidiaries are exempt from I.R.C. To claim the benefit, the following requirements must be met:

- A 10% direct or indirect minimum participation must have been held continuously for at least one year prior to the distribution or sale. If a participation in a domestic or inbound dividend has been held for less than one year at the time of the distribution, the participation regime may still apply if the



*“Portugal provides an attractive tax regime applicable to collective investment vehicles.”*

participation is retained until the one-year period has been met. This exception to the one-year holding period obviously cannot apply to capital gains on the disposal of shares.

- The shareholder must not be a tax transparent company under the regime provided in Article 6 of the C.I.R.C. The Portuguese tax transparency regime is restricted to companies that are resident for tax purposes in Portugal.
- The company effecting the distribution must be subject to income tax that is imposed at a nominal tax rate of at least 12.6% and must not be located in a tax-favored jurisdiction. The latter occurs when a subsidiary is resident in a tax haven jurisdiction, or the corporate income tax actually paid by the subsidiary is less than 50% of the tax that would be due under the C.I.R.C. rules. In this context, Portugal has an internal tax-haven list, that includes approximately 80 jurisdictions. This list is not aligned with other tax haven lists, such as the E.U. list.
- The capital gain does not relate to the sale of shares in a Portuguese real estate company, which is a company in which more than 50% of its asset value is attributable to real property in Portugal acquired on or after January 1, 2014. Real estate used for carrying on an agricultural, industrial, or commercial activity is not taken into account as Portuguese real estate for purposes of determining the status of the company. This exclusion covers real estate in the form of office buildings, hotels, lease arrangements, and land held for agricultural use.

Rules and exemptions regarding nonresident companies with subsidiaries in Portugal are discussed below in text related to nonresident companies.

## **SPECIAL TAX REGIME APPLICABLE TO COLLECTIVE INVESTMENT VEHICLES**

### **General**

Portugal provides an attractive tax regime applicable to collective investment vehicles. The regime was introduced by Decree-Law No. 7/2015, of January 13, and is construed as a tax incentive provided in Article 22 *et. seq.* of the Tax Incentives Statute.

The collective investment vehicles may be organized in fund or company form. They may also be open or closed, depending on whether the respective units are of a variable or a fixed number. Incorporation of a collective investment vehicle in Portugal is subject to prior authorization by the Securities and Exchange Commission.

The types of assets in which collective investment companies are able to invest will vary depending on how they are set-up. Generally speaking, Securities Investment Funds and Companies are set-up for the purposes of investing in financial assets, whereas real estate investment companies are set-up for the purposes of investing in real estate or related assets.

The collective investment vehicles tax regime provides for a typical exit taxation system, where taxation is shifted to investors. One of the main benefits of the regime is the fact that the vehicle itself, although subject to tax, can in practice be

virtually exempt from I.R.C. because most relevant income streams are excluded from taxation.

Portugal considers investment companies to be resident taxpayers that are subject to corporate tax in Portugal, albeit with an exclusion of certain income from the taxable base. Although open to question, it was the goal of the commission that introduced the regime that the collective investment vehicles would have access to Portugal's income tax treaty network and benefit from E.U. directives.

The taxable income of the vehicle reflects the net result of the period computed in accordance with generally accepted accounting standards applicable to collective investment vehicles. However, investment income such as dividends, interest, rental or property income in the case of real estate investment companies, and capital gains realized from the disposal of investments are excluded from the tax base, unless the income is related to entities resident or domiciled in a tax haven jurisdiction. The exclusion covers realized or potential income that reflects fair value accounting and forex gains and losses.

Some aspects of the standard I.R.C. regime remain applicable, such as standalone taxation on certain expenses, or the disallowance of expenses such as excessive, unrelated, or unsubstantiated expenses. Understandably, expenses incurred in connection to exempt income are not deductible. This covers items such as management fees.

To the extent that any taxable income arises, it would be subject to the standard corporate tax rate of 21%, but an exemption from the municipal and state surcharges apply. Management companies are joint and severally liable for the tax debts of the vehicle. Tax losses may be carried forward for five years.

### **Stamp Duty**

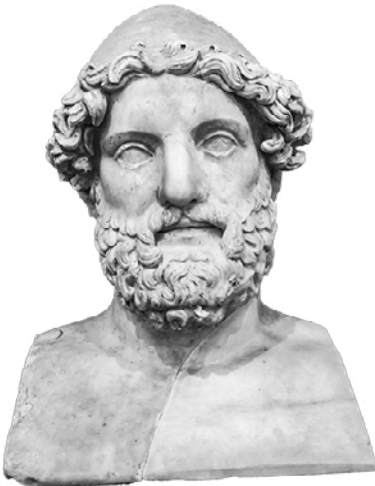
Despite the above-mentioned income tax regime, Portuguese resident securities investment funds are subject to stamp duty that operates as a registration tax. The tax charge is levied quarterly on the funds' net asset value at the following rates:

- 0.0125% per quarter in the case of real estate investment companies
- 0.0025% per quarter in the case of securities investment funds investing in monetary instruments or deposits

In principle, collective investment vehicles are also subject to stamp duty charges on financial operations, such as the granting of credit and guarantees, as well as on interest and commissions charged by financial institutions, unless an exemption for some other reason is available. The tax authorities have issued a ruling (Ruling number 2018001066 of November 1, 2018) stating that collective investment vehicles are covered by the exemption from stamp duty on the use of credit, associated guarantees, interest and commissions charged by the credit institutions is qualified as a financial institution under E.U. law.

### **Compartments**

An interesting feature of the Portuguese Collective Investment Undertaking legislation is that a regulated company or fund may be divided in various separate compartments which can, within the same legal entity, fully segregate the assets and



liabilities of each compartment and determine different distribution policies for the compartments. To the extent that a vehicle is divided into compartments, the rules apply to each of the compartments independently.

### **M&A Operations**

The general tax neutrality regime for M&A transactions may apply to collective investment vehicles. This is discussed in **Tax Neutrality Regime: Reorganizations / M&A**. Transactions not entitled to tax neutrality regime may be taxable on general terms.

### **Value Added Tax**

Collective Investment Vehicles are in principle taxable persons for V.A.T. purposes. However, their supplies are usually connected with financial operations, generally exempt from V.A.T. Notwithstanding recurring debates with the tax authorities on the V.A.T. impact on holding activities,<sup>2</sup> the exemption is not zero-rating. Therefore, it does not provide for the right to deduct the V.A.T. incurred in connection with expenses related to such income. Consequently, the V.A.T. borne by a collective investment vehicle constitutes an effective cost of the vehicle. This, however, should not be the case in relation to V.A.T. incurred on expenses connected with V.A.T. taxable activities performed by the vehicle.

### **Taxation of Income Obtained in Portugal by Other E.U. Member-States Resident Collective Investment Vehicles**

A strictly literal view of the wording of the regime may suggest that the tax incentives above are not applicable to collective investment vehicles established outside Portugal. However, decisions from Tax Arbitration Courts in Portugal have addressed the potential discrimination against vehicles incorporated in other E.U. Member States. These cases addressed whether E.U. law was violated by the imposition of Portuguese withholding tax on dividends distributed by a Portuguese company (i) to a collective investment vehicle incorporated in another Member State and (ii) to a Portuguese branch of a collective investment vehicle incorporated in another Member State. In both decisions, the Tax Arbitration Courts ruled that the distinction between resident and nonresident collective investment vehicles violates the E.U. principle of free movement of capital.

The rulings do not constitute controlling precedent for other disputes. Nonetheless, the decisions suggest that tax arbitration panels would likely agree that Portuguese withholding tax should not be imposed on investment income, real estate income, and capital gains obtained in Portugal by a collective investment vehicle that is resident in a Member State of the E.U. or on comparable income received by a P.E. that is maintained in Portugal by a company that is resident in a Member State of the E.U.

In the majority of the decisions issued by Tax Arbitration Courts, the arbitration panel found that the violation of E.U. law was clear and therefore did not request preliminary rulings from the European Court of Justice (“E.C.J.”). However, an arbitration panel referred the question to the E.C.J. In March 2022, the E.C.J. ruled that legislation under which dividends distributed by resident companies to a nonresident

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<sup>2</sup> It is anticipated that this debate will disappear given the clear C.J.E.U. case law on the topic.

collective investment vehicle are subject to withholding tax but dividends distributed to a resident collective investment vehicle are exempt from that tax is contrary to E.U. law.<sup>3</sup>

### **Taxation of the Investors**

As mentioned above, the Portuguese regime for collective investment vehicles excludes income derived from qualifying activities from the tax base. As such, these companies typically pay little or no tax in Portugal, notwithstanding their *prima facie* taxable status. This benefit is offset at the time distributions are made to investors. Portuguese taxation in the form of a withholding tax is levied on distributions made by the collective investment vehicle to its investors. The Portuguese taxation on distributions will vary depending on the residence of the investor and its status as a corporation or an individual.

Individual investors, including Portuguese nonhabitual residents, are subject to tax on distributions and capital gains that are received from a collective investment vehicle. The personal income tax rate of 28% applies unless the participation relates to the business activity of the individual, where it is subject to tax on standard terms. If an individual taxpayer elects for the aggregation of all income received in a given tax year, only 50% of the distributions is taken into account in computing taxable income. That amount is subject to progressive tax rates of up to 48% plus a solidarity charge of 2.5% on income over €80,000 and 5% on income over €250,000.

Regarding resident corporate investors, it is open to question as to whether a tax exemption may apply under the participation exemption regime. If not, the relevant income is taxable on standard terms. In the case of real estate investment companies/funds, the Portuguese tax authorities have already issued their view that the Portuguese participation exemption regime cannot apply.

For nonresident investors, the Portuguese taxation will vary depending on the type of collective investment company that makes the distribution:

- Nonresident investors in real estate investment funds or real estate investment companies will be subject to tax on distributions made by the collective investment vehicle at a 10% flat rate.
- Income derived by nonresident participants (both companies and individuals) from securities investment funds and securities investment companies is, in principle, tax exempt in Portugal.

In any case, for the purpose of accessing the tax exemption or reduced withholding on distributions, nonresident investors must submit to the collective investment vehicle or management company adequate evidence of the nonresident status.

Some exceptions to the above apply. A nonresident corporation is not entitled to the exemption or reduction in tax if 25% or more of its shares is directly or indirectly held by individuals or companies resident in Portugal. However, the exemption may still apply if the nonresident company meets all the following conditions:

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<sup>3</sup> *ALLIANZGI-FONDS AEVN v. Autoridade Tributária e Aduaneira* (Case docket No. C-545/19).

*“If a taxable transaction is not reported, the tax is imposed the gross transactional value rather than the actual gain.”*

- It is resident in (i) an E.U. Member State, (ii) an E.E.A. member state that has entered into an administrative cooperation agreement in tax matters equivalent to the cooperation available among Member States of the E.U., or (iii) a state with which Portugal has in effect a treaty providing for the exchange of information in tax matters.
- It is subject to and not exempt from tax under the standard used in the Parent/Subsidiaries Directive, or to a tax similar to the Portuguese corporate income tax, and the applicable rate is not less than 60% of the Portuguese I.R.C. tax rate.
- It has a direct or indirect 10% shareholding or ownership of voting rights in the Portuguese collective investment vehicle for an uninterrupted period of one year.
- The structure is not considered to be part of an artificial construction having as a main purpose the intent to obtain a tax advantage.
- The second exception to favorable treatment applies to a nonresident participant based in a tax haven jurisdiction. When a distribution or a payment in redemption of units is made to that category of investor, the payment is subject to withholding tax of 35%. Capital gains from the sale of units in secondary markets by that category of investor will be subject to a 28% tax for an individual or a 25% tax for a corporation.
- The final exception to favorable treatment applies when the beneficial owner of the participant is not identified.

If the units are acquired on secondary markets, the acquisition price must be reported to the collective investment vehicle, the management company, or the custodian/depositary. If a taxable transaction is not reported, the tax is imposed the gross transactional value rather than the actual gain.

### **Real Estate Investment Trusts**

The Real Estate Investment Trusts (“R.E.I.T.’s”) regime was approved by Decree-Law No. 19/2019, of January 28, 2019, and establishes a new mechanism to invest in real estate in Portugal. The principal benefit of the R.E.I.T. is the exemption from corporate income tax for capital income (interests and dividends), rents, capital gains, and commissions.

To be qualified as a R.E.I.T. the company must meet the following requirements:

- It must be incorporated as a public limited liability company (“*Sociedade Anónima*”) with a Supervisory Board and an Official Auditor. It is possible to convert an already existing public limited liability company or a collective investment vehicle into a R.E.I.T.
- It must have minimum share capital of €5 million that is subscribed, fully paid, and represented by a single class of common shares.
- It must meet certain thresholds on assets and debts.
- It must comply with specific requirements relating to the distribution of profits.

- Its company name must include the term “*Sociedade de Investimento e Gestão Imobiliária, S.A.*” or the term “S.I.G.I., S.A.”
- After the first year and up to the end of the third year of the company, at least 20% of its shares must be listed and negotiated in a stock market or in a multilateral negotiation system. By the end of the fifth year, the minimum percentage of listed shares is increased to 25%.

In addition, the corporate purpose of the R.E.I.T. as inscribed in its articles of association must be limited to the following activities:

- The purchase of real estate, building or other property rights, leasing activities regarding the real estate, and other forms of real estate exploitation such as leasing for commercial purposes or the development of real estate by means of new construction and rehabilitation projects
- Purchase of shares in other R.E.I.T.’s or shares of companies having a place of business based in the E.U. or the E.E.A., provided that (i) the corporate scope of the target entity is equivalent to that of a Portuguese R.E.I.T., (ii) the assets of the target entity comply with the thresholds established in the Portuguese legislation, (iii) the share capital of the target company includes nominal shares, and (iv) the target company’s profit distribution policy is equivalent to the policy established in the Portuguese legislation
- Purchase of participation units or shares (i) in companies with a profit distribution policy identical to the R.E.I.T. or (ii) in companies involved in residential real property
- Purchase of participations in Leasing Real Estate Investment Funds or Residential Letting Real Estate Investment Companies

There is no limitation in terms of obtaining income from other activities, although the benefits resulting from this regime will be applicable only to the abovementioned activities.

The main tax benefit granted to R.E.I.T.’s is the exemption of corporate income tax on investment income as described above. As with other collective investment vehicles, to the extent the income is exempt from tax, the related costs are not tax deductible.

The taxation of income obtained by investors in the R.E.I.T. follows in essence the regime outlined above in relation to other collective investment vehicles:

- Income derived from investments in corporate residents will be subject to the general rules applicable to other resident companies. As mentioned above, the tax authorities have already declared to find that the participation exemption regime may not apply on distributions and capital gains. Therefore, tax withholding imposed at a 25% rate may be due in advance of the final C.I.T.
- In the case of resident individual investors, including nonhabitual residents, the payment of a dividend from the R.E.I.T. will attract a final tax withholding of 28% except when the income is linked to the economic activity of the individual.



- Foreign investors will be subject to a 10% final withholding tax unless the investor is tax resident in a tax haven jurisdiction. Because a R.E.I.T. is a corporate entity that is subject to I.R.C., the view in Portugal is that a Portuguese R.E.I.T. will be considered to be a tax resident in Portugal that is entitled to claim benefit under Portugal's treaty network and for the purposes of E.U. directives.

### **Venture Capital Funds**

Investment in venture capital can be made via a multitude of vehicles. The most common types are venture capital companies ("*Sociedades de Capital de Risco*"), venture capital fund management companies, venture capital funds, and venture capital investment companies. These companies are all regulated companies and are established under the supervision of the financial services regulators.

For regulatory purposes, venture capital is defined as the acquisition and holding for a limited period of time of shares in companies with high growth potential. As a result, the activity of venture capital companies and the funds they manage is generally limited to investment in venture capital as defined above. These companies cannot pursue other commercial purposes, although they can pursue activities that are considered auxiliary to their main purpose. Examples are the performance of financial and administrative management services.

From a tax perspective, the income of venture capital funds ("V.C.F.'s") incorporated and operating under the Portuguese legal regime is exempt from taxation. Moreover, the subscription of units in the V.C.F. does not give rise to any tax charge.

The income obtained by investors who are resident for tax purposes in Portugal will be taxed as follows:

- Individuals or companies resident for tax purposes in Portugal will be subject to a 10% withholding tax on income paid by the V.C.F. and the income resulting from a redemption of units in the fund. Although the withholding tax applicable to distributions and redemptions is the same for investors that are resident companies and individuals, a significant difference exists in the nature of the withholding tax. For corporations, the withholding tax is considered to be a prepayment of the final corporate tax that will be due on total income for the entire tax year. Ordinary corporate tax rates will apply once the year's income is computed. In comparison, the withholding tax for a resident individual is in the nature of a final tax. No further income tax is payable on that income.
- Companies that are resident in Portugal for tax purposes but tax exempt on capital gains will not be subject to withholding tax on income paid by the V.C.F. and on income from redemption of units in the fund.
- Individuals that are resident in Portugal for tax purposes will be subject to a 10% tax rate on capital gains generated by the disposal of units in the fund.
- Companies that are resident in Portugal for tax purposes will be subject to the general corporate income tax regime on capital gains made on the disposal of participation units.

Nonresident companies are exempt from Portuguese tax on distributions from a V.C.F. and redemptions of units of a V.C.F. where the following two conditions are met:

- Portuguese resident companies do not hold 25% or more of the share capital of the nonresident company.
- The nonresident company is not resident for tax purposes in a blacklisted jurisdiction.

Income received or redemptions made by nonresident individuals are subject to a 10% withholding tax.

Regarding the capital gains generated on the disposal of units, nonresident investors will generally be exempt from taxation in Portugal. This will not occur where more than 50% of the assets of the fund relate to Portuguese real estate or when the investor is resident in a blacklisted jurisdiction. If either such fact exists, a 10% tax rate on the gains made on the disposal of the units of such funds will apply.

Finally, nonresident investors will not be deemed to have a P.E. in Portugal as a result of holding units in the fund.

## NONRESIDENT COMPANIES

Nonresident companies are subject to I.R.C. on income deemed to have been obtained in Portugal.

In the 2014 corporate tax reform, Portugal introduced several tax measures aimed at attracting foreign investment. In broad terms they are aimed at (i) the elimination of withholding taxes on the payment of dividends, interest and royalties and (ii) granting tax-free treatment for capital gains arising from the sale of shares and the sale of qualifying financial instruments.

### **Dividends**

Dividends paid by a Portuguese company to a nonresident holding company can be tax exempt provided that all the following criteria are met, and the nonresident company complies with certain formalities:

- The holding company is resident in an E.U. Member State, a qualifying state within the E.E.A., or a state which has entered into a double taxation agreement with Portugal providing for the exchange of information for tax purposes. It is understood that a company is tax resident in a given state if it does not qualify as tax resident in any other state under any of the double taxation treaties entered by that state.
- The holding company holds a direct or indirect participation of at least 10% of the share capital or the voting rights of the Portuguese company.
- The participation in the Portuguese company has been held for at least one uninterrupted year prior to the distribution.
- The holding company is subject to income tax in its country of residence at a nominal rate of at least 12.6%.



- An arrangement or series of arrangements are not deemed to have been put into place for the purpose of obtaining a tax advantage that defeats the object and the purpose of elimination of double taxation.

Where the above-mentioned exemption from withholding tax does not apply, out-bound dividend payments are usually subject to withholding tax imposed at rate of 25%, unless a different rate is available under a relevant tax treaty.

### **Capital Gains**

Under the Tax Incentives Code, capital gains on the sale of shares and qualifying securities of Portuguese entities are exempt from tax when derived by qualifying nonresident companies that do not hold the qualifying assets through a P.E. in Portugal. To qualify for the capital gains exemption, the nonresident company must meet the following conditions:

- It cannot have a P.E. in Portugal, or if one exists, the P.E. cannot be involved in the sale of the assets.
- It cannot be a resident for tax purposes in a blacklisted jurisdiction.
- It cannot be owned by a Portuguese resident company or individual, or if such ownership exists, the Portuguese shareholders own less than 25% of the nonresident company.

The capital gains exemption also applies where the seller is a resident of (i) an E.U. Member State, (ii) a state within the E.E.A., or (iii) a state that has an income tax treaty in effect with Portugal that provides for the exchange of information for tax purposes.

As with the exemption for dividends, the following conditions must be met in order to claim the benefit in connection with gains derived by a foreign corporation:

- The seller must be subject to corporate income tax at a nominal tax rate of at least 12.6%.
- The participation must be all or part of a direct or indirect holding of at least 10% of the company that issued the shares.
- The participation must have been held for an uninterrupted period of at least one year prior to the sale.
- The sale must not part of an arrangement put into place for the purpose of obtaining a tax advantage that defeats the object and the purpose of elimination of double taxation.

As mentioned previously, the regime does not apply to a sale of shares if, at any given time in the year prior to the sale, the company issuing the shares derives more than 50% of its value from real estate located in Portugal. An exception to this rule applies where the immovable property is used for carrying out an agricultural, industrial or commercial activity, other than the purchase and resale of real estate.

If the tax exemption does not apply, capital gains derived by nonresident companies without a P.E. in Portugal are subject to a flat 25% tax imposed on the gain, unless a

*“As mentioned previously, the regime does not apply to a sale of shares if, at any given time in the year prior to the sale, the company issuing the shares derives more than 50% of its value from real estate located in Portugal.”*

lower rate is available under a relevant income tax treaty. However, if the company is tax resident in a blacklisted jurisdiction, the tax rate is increased to a 35% tax rate.

### **Interest and Royalties**

Following the transposition of the Interest and Royalties Directive (“I.R.D.”), interest or royalty payments to companies resident in an E.U. Member State or Switzerland are exempt from tax on the receipt of interest or royalties if the requirements set forth in the I.R.D. are fulfilled.

This exemption may be denied if the nonresident company does not have its Beneficial Ownership registration up to date or it reflects an arrangement or series of arrangements that have been put into place for the purposes of obtaining a tax advantage that defeats the object and the purpose of elimination of double taxation.

## **INCOME TAX TREATIES**

As of the date of this article, Portugal has in force and effect 77 treaties to avoid double taxation, as listed below:

Algeria	Ethiopia	Macao	Senegal
Andorra	France	Malta	Singapore
Angola	Georgia	Mexico	Slovakia
Austria	Germany	Moldova	Slovenia
Bahrain	Greece	Montenegro	South Africa
Barbados	Guinea-Bissau	Morocco	South Korea
Belgium	Hong Kong	Mozambique	Spain
Brazil	Hungary	Netherlands	Switzerland
Bulgaria	Iceland	Norway	Tunisia
Canada	India	Oman	Turkey
Cape Verde	Indonesia	Pakistan	Ukraine
Chile	Ireland	Panama	U.A.E.
China	Israel	Peru	U.K.
Colombia	Italy	Poland	U.S.A.
Croatia	Ivory Coast	Qatar	Uruguay
Cuba	Japan	Romania	Venezuela
Cyprus	Kuwait	Russia	Vietnam
Czech Republic	Latvia	San Marino	
Denmark	Lithuania	São Tomé Príncipe	
Estonia	Luxembourg	Saudi Arabia	

### **M.L.I.**

Portugal signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the “M.L.I.”) June 7, 2017, having deposited the Instrument of Ratification on February 28, 2020. In respect to Portugal, the M.L.I. entered into force on June 1, 2020.

Regarding the M.L.I., listed below are some highlights on the key reservations and notifications made by Portugal.

### **Transparent Companies**

Pursuant to Article 3(5)(a) of the M.L.I., Portugal reserved the right not to apply the Article to its Covered Tax Agreements. Article 3 of the M.L.I. relates to hybrid mismatches. This policy statement was noted in the reservations made by Portugal to the Commentaries to the O.E.C.D. Model Convention and has been consistently applied by the Portuguese tax authorities in various rulings.

### **Dual Resident Companies**

Article 4 of the M.L.I. relates to dual resident companies. Pursuant to Article 4(3)(a) of the M.L.I., Portugal reserved the right for the entirety of Article 4 to opt out of the provision with regard to its Covered Tax Agreements.

### **Capital Gains from Alienation of Shares or Interests of Companies Deriving their Value Principally from Immovable Property**

Article 9 deals with the taxation of gains from the sale of real property holding companies. Pursuant to Article 9(8) of the M.L.I., Portugal chose to apply Article 9(4). This provision is in line with Portugal's internal corporate income tax legislation.

## **ANTI-AVOIDANCE MEASURES**

In various provisions of Portuguese tax law discussed above, several anti-avoidance and anti-abuse rules were discussed with regard to the claim of a specific benefit under domestic law. Here, we discuss rules that have broader application to domestic and international business transactions.

### **General Anti-Abuse Rule (“G.A.A.R.”)**

The Portuguese tax system contained a G.A.A.R.<sup>4</sup> provision long before the introduction of the Anti-Avoidance Directive. Recently, the text of the Portuguese G.A.A.R. was adapted to be in line with A.T.A.D.

Under the current version of G.A.A.R., a transaction or set of transactions may be disregarded for tax purposes whenever it is proved that their main purposes, or one of their main purposes was obtaining a tax advantage that defeats the object or purpose of the law, namely avoiding tax that would otherwise be due.

Hence the application of the G.A.A.R. usually involves the existence of wholly artificial arrangements, or arrangements with abuse of legal forms, put into place to reduce, eliminate or defer the tax normally due or to obtain an undue tax advantage. Following the adoption of A.T.A.D. by the Commission, the law clarifies that an arrangement is deemed artificial or non-genuine to the extent that it was put into place with no valid commercial reasons and does not reflect economic reality. The application of the G.A.A.R. implies that taxation should follow standard terms applicable to a particular business transaction and assumes that the parties will act in a way that reflects the true economic substance of the operation, with the removal of the undue tax advantages.

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<sup>4</sup>

Set forth in Article 38 of the General Tax Law.

## **Controlled Foreign Company (“C.F.C.”) Rules**

The C.I.R.C. contained provisions relating to C.F.C. rules for many years. Again, those provisions were amended by the law transposing the A.T.A.D.

Under the current version of the C.F.C. rules, individuals and corporations that are tax resident in Portugal are subject to the C.F.C. provisions when holding directly, indirectly, or through a fiduciary or an agent, at least 25% of the shares, voting rights, profit rights, or assets of a nonresident company that is subject to a low-tax or no-tax regime.

For a nonresident company to be subject to a low-tax regime, at least one of the following tests must be met:

- The corporate income tax effectively paid abroad on the profits of the C.F.C. is less than 50% of the I.R.C. that would have been due under Portuguese corporate income tax rules.
- The jurisdiction where the C.F.C. is established is included in the Portuguese blacklist of low-taxed jurisdictions.

The C.F.C. regime will not result in the imposition of tax on a Portuguese resident as long as the specified passive income amounts to less than 25% of total gross income of the C.F.C. The specified passive income categories are the following:

- Interest or any other income generated by financial assets
- Royalties or any other income generated from intellectual property, personality rights, and the like
- Dividends and income from the disposal of shares
- Income from financial leasing transactions
- Income from insurance, banking and other financial activities
- Income from re-invoicing companies that earn sales and services income from goods and services purchased from, and sold to, associated enterprises, and that add no or little economic value

In respect to a foreign company resident in the E.U., the C.F.C. rules are not applicable as long as a certain level of substance, human capital, and material resources are present and contribute to the business activity.

## **Blacklist of Low-Taxed Jurisdictions**

Through various Orders,<sup>5</sup> the Portuguese government has adopted the following blacklist of low-taxed jurisdictions as of January 1, 2021.

American Samoa	Falkland Islands	Marshall Islands	St. Helena
Anguilla	Fiji	Mauritius	St. Kitts & Nevis
Antigua & Barbuda	French Polynesia	Monaco	St. Lucia

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<sup>5</sup> Order No. 150/2004, of February 13, as amended by Order No. 345-A/2016, of December 30, and by Order No. 309-A/2020, of December 31.

Aruba	Gambia	Montserrat	St. Pierre & Miquelon
Ascension Island	Gibraltar	Nauru	St. Vincent & Grenadines
Bahamas	Grenada	Netherlands Antilles	Svalbard Islands
Bahrain	Guam	Niue	Swaziland
Barbados	Guyana	Norfolk Island	Tokelau
Belize	Honduras	North Mariana Islands	Tonga
Bermuda	Hong Kong	Oman	Trinidad & Tobago
Bolivia	Isle of Man	Palau	Tristan da Cunha
Brunei	Jamaica	Panama	Turks & Caicos
B.V.I.	Jordan	Pitcairn Island	Tuvalu
Cayman Islands	Kiribati	Puerto Rico	U.A.E.
Channel Islands	Kuwait	Qatar	U.S.V.I.
Christmas Island	Labuan	Queshm Island	Uruguay
Cocos (Keeling)	Lebanon	Samoa	Vanuatu
Costa Rica	Liberia	San Marino	Yemen
Djibouti	Liechtenstein	Seychelles	
Dominica	Maldives	Solomon Islands	



# UNITED KINGDOM

**Author**  
Eloise Walker  
Pinsent Masons LLP  
London

## INTRODUCTION<sup>1</sup>

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

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

### Individuals

The U.K. has a unique taxation system for individuals who are resident but not domiciled in the U.K. known as the “remittance basis.” Individuals who are eligible to use the remittance basis are only liable to U.K. tax on foreign-source income and capital gains to the extent that those amounts are remitted to the U.K. This system has made the U.K. an attractive and cost-effective center for locating foreign executives.

Non-domiciled individuals (“Non-Doms”) seeking to benefit from the remittance basis must pay a tax charge if they have been resident in the U.K. for seven or more of the last nine tax years. The charge, known as the remittance basis charge (“R.B.C.”), increases as the period of U.K. residence increases. For tax years from to April 6, 2017, the following rates of R.B.C. apply:

- **£60,000:** Applicable to Non-Doms that have been resident in the U.K. for 12 of the last 14 tax years (the “12-year test”)
- **£30,000:** Applicable to Non-Doms that do not meet the 12-year test but have been resident in the U.K. for seven of the last nine years

When the R.B.C. was first introduced, it applied as a single £30,000 charge for individuals resident in the U.K. for seven of the last nine years. Since then, the R.B.C. has been amended and increased several times, in various attempts to restrict tax benefits for individuals that have been resident in the U.K. for an extended period. Consequently, different levels of the R.B.C. may apply for individual tax years between April 2008 and April 2017. Prior To April 6, 2017, a third rate of the R.B.C. of £90,000 applied to Non-Doms that had been resident in the U.K. for 17 out of the last 20 tax years (the “17-year test”).

From April 2017 onwards, individuals who have been resident in the U.K. for at least 15 of the previous 20 tax years are deemed to be domiciled in the U.K. from the beginning of the sixteenth tax year.

Consequently, these individuals are no longer eligible to claim the remittance basis and are taxed in the U.K. on their worldwide income and gains. As a result, the £90,000 R.B.C., which applied under the 17-year test, became redundant.

<sup>1</sup> This summary of U.K. law is correct as of June 4, 2022.

The author would like to acknowledge the contribution of Penny Simmons, a legal director of Pinsent Masons LLP, London, in its preparation.

An important R.B.C. relief was introduced in April 2012, whereby foreign income and gains may be brought into the U.K. for the purpose of investing in certain U.K. companies without constituting a taxable remittance that is subject to U.K. tax. The relief applies to investments in private U.K. companies only. Broadly, the investment can be made by way of shares or debt and must be made within 45 days of the funds being brought into the U.K. The relief is not available where the funds are being remitted as part of a scheme or arrangement to avoid U.K. tax.

Foreign executives coming to work in the U.K. should also be aware of certain measures, 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. 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%. From April 2023, this rate is increasing to 25% and a reduced rate of corporate income tax at 19% will be available for companies with profits of £50,000 or less. Companies with profits between £50,000 and £250,000 will be taxed at a rate of 23% but will be eligible to claim marginal relief.
- An exemption from corporate income tax is available for most dividends received from U.K.- and foreign-resident companies and is backed up by a foreign tax credit system where the exemption does not apply.
- No withholding tax is levied on dividends paid by U.K. companies to nonresident shareholders, except for distributions made by certain types of investment funds, such as real estate investment trusts (“R.E.I.T.’s”).
- The U.K. offers an exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups. In general, there is no C.G.T., on the sale of shares in U.K. companies by nonresidents (except for certain companies with substantial interests in U.K. real estate, as discussed further below).
- There are no capital taxes on formation or paid-in capital of companies.
- Prior to July 1, 2016, the U.K. had in place an optional “Patent Box” regime to incentivize U.K. innovation and the development and retention of certain intellectual property rights. The regime was introduced in April 2013. Broadly speaking, the regime allowed qualifying companies to elect to apply a lower rate of U.K. corporate income tax on all profits attributable to qualifying

*“There is an above-the-line R&D Expenditure Credit for qualifying companies that incur qualifying R&D expenditure.”*

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, provided an effective corporate income tax rate of 10% on worldwide profits attributable to qualifying patents and similar I.P. rights. Following recommendations from the O.E.C.D. that were published in October 2015, the original Patent Box regime was closed to new entrants as of June 30, 2016, and was abolished for existing claimants in June 30, 2021.

- 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 undertaken in developing the patent or product actually takes place. It seeks to ensure that substantial economic activities are undertaken in the jurisdiction in which a preferential I.P. regime exists, by requiring tax benefits to be connected directly to the R&D expenditure. Further changes to the new Patent Box regime were introduced in Finance (No. 2) Act 2017 to address fact patterns involving shared R&D undertaken by two or more companies. For accounting periods beginning from April 1, 2017, onwards, where R&D is undertaken collaboratively by two or more companies under a “cost sharing arrangement,” the companies involved are treated neutrally so that neither is disadvantaged or advantaged by the arrangement.
- There is an above-the-line R&D Expenditure Credit (“R.D.E.C.”) for qualifying companies that incur qualifying R&D expenditure. 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. From April 1, 2020, the R.D.E.C. is 13% and although it is available to both large and small companies, it is more commonly claimed by larger companies. A separate regime allowing for an effective tax deduction of 230% of qualifying R&D expenditure for small- or medium-sized companies (“S.M.E.’s”) is also available provided certain conditions are met.
- At the U.K.’s Budget in March 2021, it was announced that the government would conduct a wide-ranging review into the U.K.’s R&D tax credit system with the stated objective of ensuring that the U.K. remains a competitive location for cutting edge research, that the reliefs continue to be fit for purpose, and that taxpayer money is effectively targeted. At the 2021 Budget, the government also confirmed that it would legislate to enable expenditure on data and cloud computing to qualify for R&D tax credits. At the U.K.’s Budget in October 2021, it was announced that territoriality restrictions would be introduced, whereby tax relief will no longer be available for R&D expenditures on non-U.K. R&D activities. The stated objective of the new restriction is to ensure that U.K. R&D tax reliefs incentivize U.K. innovation and are appropriately targeted in a way that best benefits U.K. industry.
- It is expected that there will be an exemption from the restriction for overseas R&D where there are “material factors such as geography, environment, population, or other conditions that are not present in the U.K.” that are required for the U.K. R&D activity to be undertaken. Overseas expenditure will also remain eligible for U.K. R&D tax relief where there are regulatory or other legal requirements that activities must take place outside the U.K.



- It is currently expected that new restrictions will be introduced from April 2023. Measures are also included to curb abusive practices. From April 2023, the definition of R&D costs that are eligible for tax relief will be expanded to include cloud computing, data costs, and pure mathematics.
- The U.K. has the most extensive tax treaty network in the world, covering around 130 countries.

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 (“E.C.J.”) and the U.K. courts. Key E.C.J. decisions include

- the *Franked Investment Income/Foreign Dividend Group Litigation*<sup>2</sup> (see below),
- the *Cadbury Schweppes plc v. H.M.R.C.*<sup>3</sup> (see below), and
- the *Thin Cap Group Litigation*.<sup>4</sup>

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”), which has itself then undergone substantial revision in later Finance Acts to form part of a suite of provisions to limit the benefit of corporate interest expense deductions so that they are linked to the corporation’s E.B.I.T.D.A.

Another notable E.C.J. decision that affects the U.K.’s status as a holding company jurisdiction is the *Marks & Spencer plc v. Halsey* decision.<sup>5</sup> 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.

The original date set for the U.K. to formally leave the E.U. was March 29, 2019. However, following agreement with the E.U., this date was changed twice, firstly to October 31, 2019 and then to January 31, 2020. On January 31, 2020, the U.K. formally left the E.U. The U.K. then entered a transition period, which ended on

<sup>2</sup> *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, Case C-446/04 [2006] E.C.R. I-11753.

<sup>3</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995.

<sup>4</sup> *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue*, Case C-524/04, [2007] E.C.R. I-02107.

<sup>5</sup> *Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes)*, Case C-446/03, [2005] E.C.R. I-10837.

December 31, 2020. During this period, all existing E.U. law, including previous decisions by the Court of Justice of the European Union (“E.C.J.”), continued to apply to the U.K., although the U.K. was no longer an E.U. Member State. The goal was to maintain legal certainty in connection with the exit. On December 24, 2020, the U.K. and E.U. agreed the E.U.-U.K. Trade Cooperation Agreement (“T.C.A.”), which defines the post-Brexit trading relationship between the E.U. and the U.K. from January 1, 2021. The U.K. has enacted the E.U. (Future Relationship) Act 2020, which makes provision to implement the T.C.A. in the U.K.

E.U. legislation continues to apply to U.K. tax legislation if it falls within the definition of retained E.U. law. Few changes have been introduced to the U.K. tax rules to remove E.U. law, and most previous judgments of the E.C.J. continue to apply when interpreting retained E.U. law.

## **CORPORATE INCOME TAX RATE**

As previously noted, the main rate of U.K. corporate income tax is currently 19%, although it is increasing to 25% from April 2023.

### **U.K. Companies**

A company tax resident in the U.K. is liable to U.K. corporate income tax on its worldwide income and gains. Generally, capital gains realized by a U.K. company are included in profits for the purposes of calculating corporate income tax and are taxed at the same rate as income (currently 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. Generally, capital gains are taxed on realization.

### **Non-U.K. Companies**

Generally, a company that is not tax resident in the U.K. is liable to U.K. tax only on certain items of U.K.-source income and gains, such as rental income, and is generally taxed within the income tax regime. Most other U.K. income is taxable only to the extent that U.K. tax is withheld at the source, such as on certain interest payments.

However, a non-U.K. company may still be liable for U.K. corporate income tax if it trades in the U.K. through a U.K. permanent establishment, such as a branch or agent. In this case, the nonresident company would be liable for U.K. tax on worldwide income and gains related to that permanent establishment.

Under provisions introduced by Finance Act 2019 and effective April 2020, non-U.K. companies carrying on a U.K. real estate business or receiving income from U.K. real estate are liable for U.K. corporate tax on U.K.-related real estate income. This income includes profits arising from loan relationships or derivative contracts

for which the company is a party for the purposes of its U.K. real estate business, electric-line wayleaves, and post-cessation receipts from U.K. property businesses.

U.K. corporate tax is applied as though the entity were a U.K. tax resident, and therefore, other U.K. tax rules apply to the non-U.K. company when computing the U.K. corporate tax payable. Such provisions include (i) restrictions on interest deductibility specific to the corporate tax regime, (ii) the use of corporate losses, and (iii) the corporate tax Installment payment regime.

Effective April 2019, a nonresident company is liable to U.K. tax on gains realized on disposals of U.K. real estate. This is discussed in greater detail below.

### **Annual Tax on Enveloped Dwellings (“A.T.E.D.”)**

Certain non-U.K. companies (and other U.K. and non-U.K. “non-natural persons”) that hold certain high-value (*i.e.*, over £500,000) U.K. residential real estate assets are subject to an annual charge. The A.T.E.D. amount increases as the value of the real estate asset increases. The lowest rate is currently £3,800 (for real estate valued at more than £500,000 but less than £1,000,000), whilst the top rate is currently £244,750 (for real estate valued at more than £20 million).

Originally, the A.T.E.D. applied only to residential real estate assets valued at more than £2 million, but subsequent Finance Acts extended the scope of the tax so that the A.T.E.D. applies to residential real estate assets valued at more than £500,000. There are certain reliefs from the A.T.E.D. for genuine real estate development companies and rental companies.

### **Disposals of U.K. Real Estate Subject to A.T.E.D. Prior to April 6, 2019**

When an asset fell within the scope of the A.T.E.D. charge, the disposal of that asset was subject to 28% C.G.T. (“A.T.E.D.-related C.G.T.”). With respect to these disposals, U.K. companies were 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 was possible that a disposal could 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. was applied first, and then the nonresident C.G.T. charge was applied only to gains that are not subject to A.T.E.D.-related C.G.T.

The nonresident C.G.T. charge for gains realized on disposals of U.K. residential real estate assets also applied to individuals, trustees, and personal representatives. The rate of the charge was 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.

### **Position from April 6, 2019**

With effect from April 6, 2019, the U.K. government introduced changes to the rules regarding the taxation of gains realized on the disposal of U.K. real estate by nonresidents. As a result, the A.T.E.D related C.G.T. charge was abolished. The



changes ensure that gains realized on disposals of U.K. real estate (both residential and nonresidential) are subject to U.K. C.G.T. or U.K. corporate tax on chargeable gains. The rules apply to direct and indirect disposals. For that reason, they can apply where a nonresident company disposes of an interest in an entity holding U.K. real estate.

The higher rates of C.G.T. for disposals of interests in U.K. residential real estate continue to apply for disposals by individuals, trustees, and personal representatives.

The rules also apply to indirect disposals of U.K. real estate assets by nonresidents, although the “indirect charge” will only apply if the nonresident investor has at least a 25% interest in the entity owning the property (or had that level of interest at any time in the prior five years). Ownership of related parties will be aggregated for this purpose.

## DIVIDENDS RECEIVED BY U.K. COMPANIES

In principle, all dividends or other distributions received by U.K.-resident companies – no matter where the income arises – are subject to U.K. corporate income tax, unless specifically exempt.

Distributions received by companies, other than small companies (which are subject to their own regime), are exempt if that distribution (i) falls into an exemption, (ii) does not represent a payment of interest deemed to be a distribution, and (iii) does not qualify for a tax deduction with respect to a resident of any territory outside the U.K. under the laws of that territory.

The exemptions are widely drafted, and in practice, most distributions received by a company will fall under one of the following exemptions:

- **Distributions from Controlled Companies:** Broadly, this exemption applies when the recipient, alone or in conjunction with others, is in control of the company, in accordance with the relevant definition of control.
- **Distributions with Respect to Non-redeemable Ordinary Shares:** This exemption will cover most distributions with respect to ordinary shares by U.K. companies.
- **Distributions with Respect to Portfolio Holdings:** Broadly, these are holdings of less than 10%.
- **Dividends Derived from Transactions Not Designed to Reduce Tax**
- **Dividends with Respect to Shares Accounted for as Liabilities of the Issuer Under G.A.A.P.:** These payments are usually taxed under different provisions.
- **Capital Distributions Made from Reserves Arising from a Reduction in Capital:** Distributions that are capital in nature and which fall outside of the “dividend exemption” may be subject to U.K. corporate income tax on chargeable gains, unless the Substantial Shareholding Exemption or another exemption or relief is available.

*“The higher rates of C.G.T. for disposals of interests in U.K. residential real estate continue to apply for disposals by individuals, trustees, and personal representatives.”*

Several anti-avoidance provisions exist to prevent artificial avoidance or manipulation of these exemptions. Targeted schemes include, *inter alia*, deductions given for distributions, payments effected on non-arm's length terms, and diversions of trade income. In addition, other anti-avoidance rules, including the general anti-abuse rule ("G.A.A.R.") discussed below in **G.A.A.R. and Further H.M.R.C. Powers**, may prevent a taxpayer from claiming exemptions in certain cases.

The recipient of an exempt distribution can elect not to apply an exemption with respect to a particular distribution. The election must be made within two years of the end of the accounting period in which the distribution is received.

## FOREIGN TAX CREDIT FOR U.K. COMPANIES

Where the exemptions described above do not apply, double taxation issues may arise if a U.K. corporate recipient of a non-U.K. dividend would be subject to both U.K. tax and foreign tax in the jurisdiction from which the dividend is paid. To 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 foreign tax credit relief under the particular circumstances of the U.K. corporate resident.

Generally, companies pay dividends out of taxed profits. If a nonresident pays foreign tax on profits out of which a dividend is paid, the foreign tax payment is referred to as an underlying tax. In the U.K., an indirect foreign tax credit may be allowed for underlying tax where the recipient is a U.K. tax resident company. Typically, this underlying tax credit will be available only where the U.K. recipient company has a substantial interest in the foreign payer.

Broadly, to meet the substantial interest standard, the recipient must directly or indirectly control, or be a subsidiary of a company that indirectly or directly controls, 10% or more of the voting power of the payer company. 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). An example of the type of tax caught by this limitation is the tax paid by Maltese corporations and refunded to its shareholders.

### **Source of Income**

Although the U.K. does not have a "basket" system for allocating foreign tax credits, the "source" doctrine has imposed significant restrictions on the pooling of foreign

tax credits. The shares in a foreign company constitute a distinct source, and the foreign tax may only be credited against income from that particular source. In certain cases, a particular class of shares in a company may be a distinct source.

### **Credit Pooling**

Previously, the U.K. had a relatively complex regime of “onshore pooling” of foreign tax credits, allowing excess foreign tax credits from one source to be applied against the U.K. tax due on other foreign-source dividends. However, this regime has been discontinued in conjunction with the Substantial Shareholding Exemption. In the majority of cases, there will now be no U.K. tax liability levied on the corporate recipient of an overseas dividend and, therefore, there is no need for a credit pooling system to relieve any associated U.K. tax liability.

### **Anti-Avoidance**

A broad anti-avoidance rule, specifically aimed at foreign tax credits, exists to combat arrangements designed to secure excessive foreign tax credits, such as “dividend buying” schemes, where extra income is deliberately purchased to enhance the foreign tax credit of the purchaser. The rule applies where four conditions are satisfied:

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

Broadly, schemes or arrangements are those that meet any of the following criteria:

- The scheme or arrangement enables attribution of foreign tax, when the foreign tax is properly attributable to another source of income or gains.
- The scheme or arrangement concerns the effect of paying foreign tax, so that on entering the scheme it would be reasonable to expect that the total amount of foreign tax would be increased by less than the amount allowable as a tax credit.
- The scheme or arrangement involves deemed foreign tax, where an amount is treated as if it were foreign tax paid and either no real foreign tax would reasonably be expected to be paid or it would be reasonable to expect that the increase in foreign tax credit allowed exceeds the increase in actual tax paid.
- The scheme or arrangement concerns claims or elections for tax credits the effect of which is to increase or give rise to a claim for a relief by way of a tax credit.
- The scheme or arrangement reduces a person’s reported tax liability.
- The scheme or arrangement involves tax-deductible payments.

H.M.R.C. will issue a counteraction notice where it has reasonable grounds to determine that one or more of the above scheme-related criteria have been met. Taxpayers will then have 90 days to determine whether to (i) accept H.M.R.C.'s application of the legislation and amend 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 to shareholders who are not within the scope of U.K. corporate tax (which can include companies not resident in the U.K.). This may be reduced by an applicable U.K. income tax treaty. Since a company will not be able to qualify as a R.E.I.T. if it has a corporate shareholder with a 10% or greater participation, treaty relief will be at the rate applicable to portfolio dividends. This rate currently is 15% for qualified U.S. residents under the U.K.-U.S. Income Tax Treaty. The position is essentially the same with respect to the 20% withholding that applies to P.I.D.'s made by property-authorized investment funds.

## **DIVERTED PROFITS TAX**

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. However, it is set to be increased to 31% from April 1, 2023, when the main rate of corporate income tax is



increased to 25%. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Companies likely to be affected by D.P.T. will often seek to restructure their operations, so as to derive profits in the U.K. and be subject to the lower U.K. corporate tax rate.

D.P.T. applies to diverted profits arising on or after April 1, 2015, although there were apportionment rules for accounting periods that straddled that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or permanent establishment and arrangements between connected parties “lack economic substance” in order to exploit tax mismatches. One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity in a tax haven that bears no relation to the provision of any property, service, or financing that was actually made to the U.K. subsidiary or permanent establishment.
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a permanent establishment in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. This is referred to as the “avoidance of a U.K. taxable presence.”

D.P.T. does not apply to S.M.E.’s.

Where companies or permanent establishments lack economic substance, there are two tests that must be considered: (i) the insufficient economic substance condition and (ii) the effective tax mismatch condition. If either test is met, a D.P.T. charge will be payable.

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction. Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person’s involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that have a real financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party.

There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, or to certain 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 “Seller”) and the company that issued the shares being sold (the “Target Company”). The application of the S.S.E. is automatic and a company need not make an election in order to claim the benefit.

The conditions of the S.S.E. were substantially amended following changes introduced in Finance (No. 2) Act 2017 which are applicable from April 1, 2017.

Where the S.S.E. would apply to a gain, but in fact a loss arises from the relevant transaction, that loss is disallowed for U.K. corporate tax purposes.

Broadly, the key conditions for the S.S.E. to apply relate to (i) the shares in the Target Company held by the Seller and (ii) the trading status of the Target Company and the Target’s group.

The S.S.E. legislation had previously contained conditions relating to the trading status of the Seller and its group, but these conditions ceased to apply as of April 1, 2017.

### **The Seller’s Shareholding in the Target Company (the “Shareholding Condition”)**

To satisfy the Shareholding Condition, the Seller must meet the following requirements:

- The Seller holds 10% of the Target Company’s ordinary share capital.
- The Seller is beneficially entitled to not less than 10% of the profits available for distribution to equity holders. Broadly, this includes all other ordinary shareholders in the Target Company and certain loan note holders.
- On a winding-up of the Target Company, the Seller would be beneficially entitled to not less than 10% of the assets available for distribution to equity holders.

The Seller must hold or have held the interests described above throughout a 12-month period beginning not more than six years before the date of the disposal of the relevant shares in the Target Company. For disposals taking place prior to April 1, 2017, the 12-month holding period must have occurred not more than two years prior to the eventual disposal.

From April 1, 2017 onwards, qualifying institutional investors (“Q.I.I.’s”) are not required to hold the 10% interest in the Target Company as described above. Where at least 25% of the ordinary share capital of the Seller is owned by Q.I.I.’s, the requirement relating to the Seller’s shareholding is satisfied under the following conditions:

- The Seller holds ordinary shares, or interests in ordinary shares, in the Target Company, and the cost of the acquisition of such shares or interests was at least £20,000,000 (the “Value Test”).
- The Seller’s beneficial interest in the Target Company is proportionate to the relevant shares or interests referred to for the purposes of the Value Test (or, where there is a difference in proportion, such proportion can reasonably be regarded as insignificant).

The “cost” of shares for the purposes of the Value Test means the value of the consideration given by the Seller (or on the Seller’s behalf) wholly and exclusively for the acquisition of the relevant shares or interests, together with any incidental costs of acquisition.

**Conditions Relating to the Trading Status of the Target Company (the “Trading Condition”)**

The Trading Condition requires that from the start of the latest 12-month period that is used for the purposes of determining whether the Shareholding Condition applies, the Target Company must be a “qualifying company.”

Prior to April 1, 2017, the Target Company also had to be a qualifying company immediately after the disposal of its shares. This position caused some practical difficulty in that the Seller was required to rely on a third-party buyer’s operation of the Target Company following the disposal. From, April 1, 2017, this condition is relevant only where both following facts exist:

- The relevant buyer and the Seller are connected.
- The relevant shareholding in the Target Company has been held by the Seller for less than 12 months, but the Shareholding Condition has been met by virtue of a transfer of trade to the Target Company from within the Seller’s group.

A Target Company is a qualifying company if it is a trading company or the holding company of a trading group. A trading company is a company carrying on trading activities and activities other than trading activities are not carried on “to a substantial extent.” A trading group has a similar definition, where one or more members carry on a trading activity and, when taken together, the activities of the group members do not include “to a substantial extent” activities other than trading activities. Broadly, for these purposes, H.M.R.C. considers the term “substantial” to mean more than 20%, although H.M.R.C. has cautioned that it will consider the facts and circumstances of each case when determining whether a company carries on non-trading activities to a substantial extent.

For the purpose of the S.S.E., a company will form part of a group if it is a 51% subsidiary of another company (*i.e.*, the parent). A company will be a 51% subsidiary of another company if the parent owns, directly or indirectly, more than 50% of the ordinary share capital of the subsidiary. When determining whether a group is undertaking trading activities, the group is treated as a single business.

The Target Company does not need be a U.K.-resident company for the S.S.E. to apply.

Gains derived from disposals of shareholdings that do not meet the requirements of the S.S.E. will be liable to U.K. corporate income tax. Consequently, capital losses should be allowable but may only be offset against capital gains of the company.

## CAPITAL GAINS ON THE DISPOSAL OF SHARES BY A NONRESIDENT

Generally, no U.K. tax is payable on the disposal of shares in a U.K. company by a nonresident shareholder. A limited exception exists in the case of shares in oil companies whose value is based on exploration or exploitation rights in the U.K. sector of the North Sea. C.G.T. may also be payable on gains realized from the disposal of shares forming part of the assets of a U.K. branch of a nonresident company.

However, as outlined above, from April 6, 2019, U.K. tax is payable on gains realized by a nonresident on the sale of an interest including shares in an entity holding U.K. real estate.

## CAPITAL TAX AND STAMP DUTY

In the U.K., there is no capital tax on the formation of a company or on any capital paid in. No stamp duty is paid on share subscriptions.

Transfers of shares of U.K. companies are generally liable to stamp duty or stamp duty reserve tax ("S.D.R.T.") at 0.5% of the consideration for the sale, albeit various exemptions may apply. For example, exemptions exist for certain intra-group transfers and transfers of shares on "recognized growth markets," such as the Alternative Investment Market ("A.I.M.").

Technically, stamp duty is a tax on documents. Therefore, U.K. stamp duty is payable on the sale of non-U.K. shares if the transfer document is signed in the U.K. Stamp duty must be paid by the purchaser within 30 days of signing. Failure to meet this deadline can result in penalties and interest.

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 was 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. Even though the U.K. has now left the E.U. it was confirmed by H.M.R.C. in January 2021, that the restrictions on when the higher rate of S.D.R.T. can be charged will continue to apply.

Finance Act 2016 introduced a new provision to ensure that the transfer of U.K. securities into a depository receipt facility, or clearance system following the exercise of an option, will give rise to a 1.5% stamp duty or S.D.R.T. charge on the greater of the fair market value or option strike price, as of the date of the transfer.

This change was introduced to combat the avoidance of U.K. stamp duty and S.D.R.T. arising on the transfer of shares using Deep-in-the-Money Options ("D.I.T.M.O.'s"). An option is a D.I.T.M.O. when the strike price is significantly below fair market value.

Finance Act 2019 further updated the rules relating to the stamp duty and S.D.R.T. payable on documents transferring or agreements to transfer listed securities to connected companies. Effective October 29, 2018, the rate for such transfers will be the higher of the consideration for the transfer, or the market value of the listed securities.

With effect from July 22, 2020, the U.K.'s Finance Act 2020 extended this rule to the transfer of unlisted securities to connected companies, where some or all of the consideration for the transfer consists of the issue of shares. There must be some consideration for the rule to apply and therefore the rule does not apply to transactions such as gifts or distributions *in specie*.

## TAX TREATY NETWORK

As noted above, the U.K. has one of the most extensive tax treaty networks in the world – treaties are in effect with over 130 jurisdictions, listed below:

Albania	Fiji	Liechtenstein	Sierra Leone
Algeria	Finland	Lithuania	Singapore
Antigua & Barbuda	France	Luxembourg	Slovakia
Argentina	Gambia	Macedonia	Slovenia
Armenia	Georgia	Malawi	Solomon Islands
Australia	Germany	Malaysia	South Africa
Austria	Ghana	Malta	South Korea
Azerbaijan	Greece	Mauritius	Spain
Bahrain	Grenada	Mexico	Sri Lanka
Bangladesh	Guernsey	Moldova	St. Kitts & Nevis
Barbados	Guyana	Mongolia	Sudan
Belarus	Hong Kong	Montenegro	Swaziland
Belgium	Hungary	Montserrat	Sweden
Belize	Iceland	Morocco	Switzerland
Bolivia	India	Myanmar	Taiwan
Bosnia & Herzegovina	Indonesia	Namibia	Tajikistan
Botswana	Ireland	Netherlands	Thailand
Brunei	Isle of Man	New Zealand	Trinidad & Tobago
Bulgaria	Israel	Nigeria	Tunisia
B.V.I.	Italy	Norway	Turkey
Canada	Ivory Coast	Oman	Turkmenistan
Cayman Islands	Jamaica	Pakistan	Tuvalu
Chile	Japan	Panama	Uganda
China	Jersey	Papua New Guinea	Ukraine
Croatia	Jordan	Philippines	U.A.E.
Cyprus	Kazakhstan	Poland	U.S.A.
Czech Republic	Kenya	Portugal	Uruguay
Denmark	Kiribati	Qatar	Uzbekistan
Egypt	Kosovo	Romania	Venezuela
Estonia	Kuwait	Russia	Vietnam
Ethiopia	Latvia	Saudi Arabia	Zambia
Falkland Islands	Lesotho	Senegal	Zimbabwe
Faroe Islands	Libya	Serbia	

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 achieve the following goals:

- To reduce the risk of double taxation where the same income is taxable in two states
- To provide certainty of treatment for cross-border trade and investment
- To prevent excessive foreign taxation and other forms of discrimination against U.K. business interests abroad
- To protect the U.K.'s taxing rights against attempts to evade or avoid U.K. tax

The latter point has become a driver for U.K. tax treaty policy, consistent with E.U. and O.E.C.D. policies.

The extensive U.K. treaty network is also significant in reducing or eliminating non-U.K. taxes on payments made to recipients that are U.K. tax resident. One specific aim of U.K. treaty policy is the elimination of withholding tax on interest and royalties. About one-quarter of the U.K. treaties achieve this goal. The remaining treaties typically reduce withholding tax rates. U.K. tax treaties commonly exempt disposals of shares from C.G.T. in the source state and almost all U.K. treaties reduce foreign withholding tax on dividends. Pursuant to the European Interest and Royalties Directive ("I.R.D."), 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. However, legislation was included in Finance Act 2021 to repeal the transposition of the I.R.D. into U.K. tax law. Subject to the terms of the relevant tax treaty, withholding taxes apply to payments of annual interest and royalties made to E.U. companies from June 1, 2021.

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 – Position Prior to April 1, 2017

Prior to April 1, 2017, the U.K. allowed 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 was determined according to the U.K.'s "Loan Relationships" rules, which govern the taxation of corporate debt. Broadly, a loan relationship exists if there is a "money debt" 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” was also introduced for arrangements entered into from November 18, 2015. The rule is very widely drafted and could potentially apply to any financing transaction where the main or one of the main purposes is to obtain a tax advantage. The rule operates to counteract any tax advantage that may result from the transaction, including an interest expense deduction. The U.K. G.A.A.R. provisions may also operate to restrict an interest deduction in certain circumstances.

A restriction on the deductibility of interest expense may also be imposed by the U.K.’s thin capitalization rules, which are contained in the transfer pricing legislation. Under these rules, an interest expense deduction may be disallowed in certain circumstances. Currently, the thin capitalization rules do not have fixed ratios or safe harbors regarding the extent to which interest is deductible.

Prior to April 1, 2017, the worldwide debt cap also operated to restrict the amount of interest that could 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 applied to any worldwide group where the net U.K. debt of the group exceeded 75% of the gross worldwide debt.

However, the worldwide debt cap rules were repealed, and new rules were implemented following the introduction of a new restriction on the deductibility of corporate interest expenses (see below).

### **The Future of Interest Deductibility in the U.K.**

From April 1, 2017, rules apply that restrict tax deductions for corporate interest payments by reference to a fixed ratio.

#### **Background to the New Rules – the B.E.P.S. Project**

The U.K. government’s decision to restrict the tax deductibility of corporate interest payments was driven by international pressure following the recommendations of the O.E.C.D.’s efforts to combat base erosion and profit shifting (the “B.E.P.S. Project”).

The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis. Following international recognition that the global tax system

needed reforming to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an Action Plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments (Action Item 4).

Action Item 4 focused on limiting B.E.P.S. via interest deductions, and specifically, on whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

### Overview of the U.K. Rules

Under the U.K. rules, tax relief for interest and certain other financing costs is limited to 30% of tax E.B.I.T.D.A., which is broadly profits chargeable to corporate income tax, excluding interest, tax depreciation such as capital allowances, tax amortization, relief for losses brought forward or carried back, and group relief claimed or surrendered.

When applying the rules, groups generally need to work out the tax E.B.I.T.D.A. of each U.K.-resident member company and each U.K. permanent establishment and add them together. The limit on deductible interest is 30% of that figure.

There is a *de minimis* allowance of £2 million per annum, which means that groups with a net interest expense below this threshold are unaffected by the fixed ratio rule.

A company can carry forward indefinitely interest expense that has been restricted under the rules. The amount of interest that is carried forward interest may 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 can carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after five years.

The restrictions apply to interest on existing loans as well as new loans, although limited grandfathering is available in certain circumstances. This is discussed in greater detail below.

### Group Ratio Rule

The rules include a group ratio rule (“G.R.R.”) based on the ratio of net interest to E.B.I.T.D.A. for the worldwide group. The G.R.R. also allows deductions up to the ratio of net interest to E.B.I.T.D.A. for the worldwide group if it exceeds the fixed ratio. This is intended to help groups with high external gearing for genuine commercial purposes by substituting the G.R.R. for the fixed ratio rule if it gets a better result for the group.

The G.R.R. is calculated by dividing the net qualifying group interest expense by the group E.B.I.T.D.A. When calculating the G.R.R., 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. can be used as an alternative to the 30% fixed ratio rule. The total amount of the deductions available under the G.R.R. are capped at 100% of tax-E.B.I.T.D.A.



***“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.”***

Interest on related-party loans, perpetual loans, and results-dependent loans is not included in the calculation of the G.R.R. A loan will not be treated as having been made by related parties where (i) 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 is an exclusion for interest paid on public infrastructure projects, known as the Public Infrastructure Exemption (“P.I.E.”). Infrastructure projects tend to be highly geared and their viability is often dependent on the availability of debt financing. Without a specific exclusion, many infrastructure projects would not get off the ground due to lack of affordable debt financing and difficulty raising equity finance.

The P.I.E. is only available if an election is made and only applies to companies where all or (significantly all) of their income and assets relate to activities involving public infrastructure assets.

### **Meaning of Public Infrastructure Assets**

For this purpose, public infrastructure assets include (i) tangible U.K. infrastructure assets that meet a “public benefit test” and (ii) buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties.

The public infrastructure asset must also have or be likely to have an expected economic life of at least ten years, and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset meets the public benefit test if it is procured by a relevant public body (such as a government department, local authority, or health service body) or will be used in the course of an activity that is or could be regulated by an “infrastructure authority.” This second limb should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset.

The exemption also applies to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a “qualifying infrastructure asset” if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. Here, “short-term basis” means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

### Third-Party Debt Requirement

The P.I.E. only applies to interest paid to third parties where the recourse of the creditor is limited to the income, assets, shares, or debt issued by a qualifying infrastructure company (not necessarily the borrower).

Guarantees from parent companies or non-infrastructure companies within the group could prevent the exemption from applying. However, guarantees provided before April 1, 2017, and certain non-financial guarantees (relating to providing the services) are ignored.

### Grandfathering Provisions

Although the restrictions apply to interest on existing loans, limited grandfathering (where existing arrangements are taken outside the scope of the new rules) is available for infrastructure companies within the P.I.E. where (i) loan relationships were entered into on or before May 12, 2016 and (ii) at least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years was highly predictable by reference to certain public contracts.

The grandfathering exemption applies to interest on loans between related parties if the conditions are satisfied.

A transitional provision also applied in the first year to enable groups to restructure to fall within the P.I.E.

### Administration of the Interest Restriction Rules

The rules operate by assessing the level of interest in the worldwide group. Any restriction on the deductibility of interest cannot be processed through a company's normal U.K. corporate tax return. U.K. companies also need to file an interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies 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 currently no withholding tax on payments of interest to U.K. banks and U.K. corporate taxpayers.

Quoted Eurobonds also benefit from an exemption from U.K. withholding tax. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized exchange.

As explained above, bilateral tax treaties may also reduce the amount of withholding tax payable on interest payments to non-U.K. lenders. Administrative burdens arise when a reduction is claimed under a treaty.

To encourage the use of private placements as an alternative form of financing, effective 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 only applies 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.

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, U.K. legislation was in effect 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.

As of January 1, 2017, the U.K.’s anti-arbitrage rules were replaced with new anti-avoidance rules, known as the “anti-hybrid rules.” These rules are based on the O.E.C.D.’s final recommendations in relation to Action Item 2 of the B.E.P.S. Project. Action Item 2 focused on the avoidance of tax using hybrid-mismatches. These arrangements exploit tax rules in different countries to enable a multinational to avoid paying tax in either country or to access excessive tax relief by deducting the same expense in more than one country. The U.K.’s anti-hybrid rules are contained in Finance Act 2016. Broadly, the rules operate to deny a U.K. tax deduction, or

to 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.

## OFFSHORE INTANGIBLES

Finance Act 2019 introduced a new tax on U.K. sales linked to intangible property held in low tax jurisdictions. The new rules, which take effect from April 6, 2019, apply a 20% tax charge on offshore receipts from intangible property. The targets of the tax are multinational groups that hold I.P. such as patents in tax havens and exploit that I.P. to generate revenue from sales to U.K. customers.

The new tax only applies to non-U.K. entities that are resident in jurisdictions which do not have a double tax treaty with the U.K. which contains a non-discrimination clause. On this basis, for the most part, the new tax is expected to be restricted to tax havens and should not affect U.S. tax resident entities generating revenue in the U.K. from intangible property held in the U.S. or other suitable double tax treaty countries.

## C.F.C.’S

### **Background**

The U.K. has anti-avoidance rules to combat tax avoidance using C.F.C.’s. A C.F.C. is a company that is resident outside the U.K. for tax purposes and controlled by one or more persons resident in the U.K. The objective of the U.K.’s C.F.C. regime is to prevent the artificial diversion of U.K.-taxable profits to subsidiaries or other corporate entities in low-tax jurisdictions.

In certain circumstances, the regime operates to attribute profits of the C.F.C. to a U.K.-resident company in the form of a C.F.C. charge. In 2010, the regime was substantially amended, largely as a result of successful challenges regarding the compatibility of the regime with E.U. law.

### **Overview of the Current Regime**

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

The rules widely define the meaning of U.K.-source income for the purposes of the C.F.C. regime. There are five categories of income that are regarded as U.K.-source and they are mutually exclusive:

- Profits of the C.F.C. that are derived from the exercise of significant functions by personnel based in the U.K. or attributable to U.K.-managed risks and assets
- Profits from the provision of finance where the capital is provided from the U.K. and the C.F.C. has profits derived, directly or indirectly, from U.K.-connected contributions



- Profits from the provision of finance in the course of a financial trade
- Profits from captive insurance relating to U.K. risks
- Profits of a subsidiary that has opted into the solo consolidation regime under the financial services regulatory rules

A company can be controlled from the U.K. by reason of, (i) shareholder control (“legal control”), (ii) ownership or entitlement to assets (“economic control”), or (iii) the treatment of the company as an undertaking by the U.K. parent for accounting purposes, even if consolidated accounts are not formally required (“accounting control”).

There are five exemptions that operate to reduce or exempt the profits falling within the C.F.C. charge. These are assessed at the entity level:

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

Virtually every provision in the C.F.C. regime contains an anti-avoidance rule based on the presence of an intent to obtain the tax benefit as a principal reason for casting a transaction through a C.F.C. As indicated above, these will apply in addition to G.A.A.R.

Under the rules, a U.K. company will not be liable to a C.F.C. charge unless it holds a qualifying interest in the C.F.C., which, broadly, is ownership of at least 25% of share capital.

Prior to January 1, 2019, an important exemption applied to finance companies that satisfied certain conditions. The finance company exemption could be full or partial, set at 75%. Where the finance company partial exemption applied, the finance C.F.C. suffered an effective U.K. tax rate of 5% when the U.K. corporate income tax rate was 19% for the 2018-2019 tax year.

However, in October 2017, the European Commission (“the Commission”) opened a formal investigation into whether provisions of the U.K.’s C.F.C. regime, including this exemption, contravened E.U. law and specifically E.U. State Aid rules. In April 2019, the Commission ruled that the exemption amounted to unlawful State Aid and that the U.K. must recover the benefit of the aid from any groups which had claimed the exemption.

In June 2019, the U.K. government formally applied to have the Commission’s decision annulled. The U.K.’s appeal was published in August 2019. Notwithstanding the ongoing appeal process, the U.K. government remains under a duty to recover the alleged State Aid from the relevant companies who have benefited from the exemption. Consequently, it has proceeded with steps for an interim recovery.

*“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.”*

In February 2020, H.M.R.C started writing to taxpayers that claimed the benefit of the exemption before January 1, 2019, requesting certain information to enable H.M.R.C to collect amounts that the Commission determined to be unlawful State Aid.

In March 2020, to help U.K. businesses dealing with the COVID-19 pandemic, H.M.R.C extended the deadline for providing this information.

In any event, the Finance Act 2019 removed the exemption for finance companies from the U.K.'s C.F.C. rules, with effect from January 1, 2019. The amendments were introduced to ensure that the rules would comply with the E.U.'s Anti-Tax Avoidance Directive ("A.T.A.D"). As a broad principle, the profits of the C.F.C. are calculated on the assumption that the U.K. accounting and tax rules apply.

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

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

A separate regime applies to the attribution of capital gains of foreign companies to U.K. residents if the foreign companies would be considered to be "close companies" had they been U.K. resident, provided a targeted anti-avoidance test is met. Broadly, a company is a close company if it is under the control of five or fewer participants or participants who are also directors.

## **TAXATION OF FOREIGN BRANCHES OF U.K. COMPANIES**

Reflecting the rationale behind the creation of a wide tax exemption for U.K.-resident companies on receipt of dividends, as explained above in **Dividends Received by U.K. Companies**, the U.K.'s tax legislation contains a broad exemption from U.K. corporate income tax for the overseas trading profits, gains, and investment income of a foreign branch of most U.K.-resident companies.

The term "branch" is a domestic equivalent of a permanent establishment and the calculation of profits falling within the exemption is determined in accordance with the income tax treaty between the U.K. and the jurisdiction where the permanent establishment is established. If no such treaty exists, the model O.E.C.D. treaty is used. Special and complex rules apply to determine which losses and other reliefs, such as capital allowances, can be claimed if the exemption is not applied.

The regime applies to branches in all countries and territories – even those that do not have a treaty with the U.K. – but an irrevocable opting-in election must be made on an individual company basis.

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

Like the C.F.C. rules, the regime contains a number of anti-avoidance rules, and G.A.A.R. provisions will also apply.

## V.A.T.

The U.K. charges V.A.T. on the supplies of most goods and services with notable exclusions, such as the supply of financial services. Currently, V.A.T. is charged at 20% (“standard rated”), although some supplies are charged at 0% (“zero rated”) and others at 5% (“reduced rated”). Ultimately, the burden of V.A.T. is intended to be borne by the final consumer. As a general principle of V.A.T. law, a fully “taxable person” should be able to recover all the input V.A.T. incurred in the course of its economic activities. The term “taxable person” is a concept used by the V.A.T. legislation to describe a person who is engaged in economic activities. Conversely, V.A.T. is not recoverable by the “end user,” which is the person who acquires supplies on which V.A.T. has been charged but who is unable to show that the supplies were used by it in connection with its economic activities.

The UK’s V.A.T. system is based on E.U. law. Following the end of the transitional period on December 31, 2020, the U.K. V.A.T. laws were no longer required to comply with the E.U.’s V.A.T. laws. Nonetheless, for the time-being, the U.K. government has opted to continue the system broadly along current E.U. lines, subject to minor changes.

In the future, the U.K. government may seek to introduce substantive 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.

A company with activity limited to the holding of shares in a subsidiary for the purpose of receiving a dividend does not carry on an economic activity for V.A.T. purposes. Therefore, any V.A.T. incurred on the costs of acquiring and holding shares by a parent company for the sole purpose of holding the shares generally is not recoverable. For V.A.T. to be potentially recoverable, the shares must be held for some other “economic” purpose. Consequently, U.K. holding companies seeking to recover V.A.T. should take steps to ensure that they carry on an “economic activity” for V.A.T. purposes. Very broadly, this will involve carrying on a business. If this can be achieved, the V.A.T. costs on share acquisitions or disposals and takeovers may be recoverable.

The V.A.T. treatment of supplies made by holding companies came under scrutiny by the E.C.J. in *A.B. v. SKF*<sup>6</sup> and by the U.K.’s Court of Appeal in *B.A.A. Limited v. The Commissioners for Her Majesty’s Revenue & Customs* (the “B.A.A. case”). In *A.B. v. SKF*, the sale of shares by SKF was found to be more than a mere passive disposal of securities. Instead, SKF demonstrated that it was actively involved in the management of its subsidiaries. This constituted an economic activity. In the *B.A.A. case*, the Court of Appeal held that V.A.T. incurred on advisors’ fees by the

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<sup>6</sup> *Skatteverket v. AB SKF*, Case C-29/08, [2009] E.C.R. I-10413.

relevant group company, in connection with the takeover of the B.A.A. plc group in 2006, was not recoverable under the particular facts involved. Although the acquiring entity carried on an “economic activity” for V.A.T. purposes, the court found that the fees incurred by it related principally to the acquisition rather than the post-acquisition business of the acquired group.

Both these cases confirm that companies contemplating a share acquisition or disposal should be able to recover V.A.T. incurred on fees if they can show an intention to make taxable supplies. The discussion contained in the *B.A.A.* decision suggests that, possibly, this may be achieved by the acquiring entity showing an intention to supply taxable services to the target upon completion of the takeover. For example, it could supply management services in return for a fee. The intention to make taxable supplies may also be established where the acquirer is grouped for V.A.T. purposes with the target after completion of the takeover and clear evidence exists in the lead-up to the transaction that an intention to report on a group basis exists. In July 2015, in the joint cases of *Larentia and Minerva*,<sup>7</sup> the E.C.J. held that a holding company that actively manages its subsidiaries should be carrying out an economic activity for V.A.T. purposes. In principle, this decision recognizes that holding companies may recover V.A.T. on advisor’s fees and other costs relating to a corporate takeover, where those costs have a “direct and immediate link” with the holding company’s economic activities.

In 2016, the V.A.T treatment of supplies made by holding companies was considered by the Upper Tribunal in the case of *Norseman Gold Plc v. H.M.R.C.* and the First Tier Tribunal in *Heating Plumbing Supplies Ltd v. H.M.R.C.* On the facts, V.A.T recovery was denied in *Norseman Gold*, but allowed in *Heating Plumbing Supplies Ltd*. In January 2016, H.M.R.C. announced that it intended to consult on reforming the U.K.’s V.A.T.-grouping rules. At the end of December 2016, H.M.R.C. published a consultation document that expressly considered whether to make any changes following recent E.C.J. decisions but no changes were introduced.

However, in May 2017, H.M.R.C. published updated guidance, confirming that V.A.T. recovery can be made where the holding company is the recipient of the supply if certain conditions are satisfied. The conditions are as follows:

- The holding company making the claim must be the recipient of the supply. H.M.R.C. considers this condition satisfied where the holding company has contracted for the supply, including by novation, and it has made use of, been invoiced, and paid for the supply.
- The holding company must undertake economic activity for V.A.T. purposes. This condition will be satisfied where the holding company makes or intends to make supplies of management services for consideration to its subsidiaries. The management services must be genuine and provided for a consideration that is more than nominal. Full recovery may not be possible if management services are not supplied to all subsidiaries.
- The economic activity must involve the making of taxable supplies. The holding company should create and retain contemporaneous evidence of its intention to make taxable supplies. Full recovery may not be possible if

<sup>7</sup> *Larentia & Minerva v. Finanzamt Nordenahm*, Joined Cases C-108-109/14, [2015] E.C.R. I \_\_\_\_ (delivered on July 16, 2015).





in addition to providing management services, the holding company makes exempt supplies in providing loans to the subsidiaries. However, H.M.R.C. guidance confirms that where the holding company is lending money to companies within a V.A.T. group and these loans can be seen to support the making of taxable supplies by the V.A.T. group, the related V.A.T. will be recoverable to the extent that the costs support taxable supplies made. This is the case whether the transactions within the group would be taxable or exempt supplies were they not disregarded because of the V.A.T. grouping.

In August 2020, H.M.R.C published a new call for evidence on potential changes to the U.K.'s V.A.T. grouping rules. In March 2021, the government announced that it would not proceed with changing the rules.

## **G.A.A.R. AND FURTHER H.M.R.C. POWERS**

### **G.A.A.R.**

The G.A.A.R. was introduced in the U.K. in July 2013, with the broad intention of counteracting “tax advantages” arising from abusive tax arrangements. This includes obtaining or increasing relief from tax. For the purposes of the G.A.A.R. provisions, a tax arrangement includes agreements, understandings, and transactions to obtain tax relief, whether or not legally enforceable. The G.A.A.R. applies to most U.K. taxes, other than V.A.T.

All of the following conditions must be satisfied for the G.A.A.R. to apply:

- An arrangement giving rise to a tax advantage is present.
- The tax advantage relates to a tax covered by the G.A.A.R.
- One of the main purposes of the arrangement is to obtain the tax advantage (taking into account all facts and circumstances).
- The arrangement is “abusive.”

Arrangements will be considered to be “abusive” if they cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances. This is referred to as the “double reasonableness test.”

The circumstances that may be considered when ascertaining whether a transaction is abusive include the following:

- Whether the substantive results of the arrangements are consistent with the underlying policy of the relevant provisions and any principles on which they are based,
- Whether the means of achieving the tax advantage was contrived or abnormal
- Whether the arrangement exploits any shortcomings in the legislation

The legislation sets out indications of a transaction that is likely to be abusive and includes cases where the tax position does not reflect the economic reality, such as when an interest expense deduction is greater, for tax purposes, than the amount actually paid. Arrangements that are in accordance with established and acknowledged H.M.R.C. practice will generally not violate G.A.A.R. principles.

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

Where the G.A.A.R. applies, H.M.R.C. will be entitled to counteract the tax advantage. To illustrate, it may deny a deduction for interest expense.

There is no clearance procedure enabling taxpayers to obtain confirmation from H.M.R.C. that the G.A.A.R. will not apply to a particular transaction. However, depending on the transaction type and circumstances, other clearances in comparable circumstances will be available over time.

H.M.R.C. has published Advisory Panel guidance on its interpretation of the G.A.A.R., including examples of where the G.A.A.R. will apply. The guidance confirms arrangements reflecting straightforward choices, such as funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, and as mentioned above, arrangements that are in accordance with long-established practice will not be subject to the G.A.A.R. unless contrived.

### **Disclosure of Tax Avoidance Schemes**

The Disclosure of Tax Avoidance Schemes (“D.O.T.A.S.”) rules were introduced in Finance Act 2004 and broadly require the promoters of certain tax avoidance schemes to disclose details to H.M.R.C. Essentially, the D.O.T.A.S. regime is intended to facilitate H.M.R.C.’s identification of potential tax avoidance schemes at an early stage, with a view to taking action to close down abusive schemes where appropriate.

Following a disclosure under D.O.T.A.S., H.M.R.C. may issue a scheme reference number (“S.R.N.”). Subsequently, taxpayers who choose to use the scheme are required to put the S.R.N. on self-assessment tax returns.

Broadly, the rules apply where (i) there are “arrangements” that are expected to provide a tax advantage, (ii) receiving a tax advantage is expected to be one of the main benefits, and (iii) the scheme falls within one of several descriptions (known as “hallmarks”). Currently, the hallmarks are aimed at new and innovative schemes, marketed schemes, and specific targeted schemes.

### **D.A.C. 6**

On June 25, 2018, E.U. Directive (2018/822/E.U.) (known as D.A.C.6.) entered into force. D.A.C.6. is designed to give E.U. tax authorities early warning of new cross-border tax schemes that might be used to avoid tax. It requires tax authorities to be notified of cross-border tax arrangements satisfying certain “hallmarks.” The tax authorities will then automatically exchange the information with other relevant E.U. tax authorities.

The rules have been in force in E.U. member states since July 1, 2020, but the first reporting obligations were deferred by most E.U. countries until 2021 because of the COVID-19 pandemic.

*“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.”*

The U.K. enacted D.A.C.6 and the U.K. government stated it was committed to applying them even after the U.K. left the E.U. However, on December 30, 2020 the government confirmed that the U.K. rules would be amended so that reporting requirements would only be required in the U.K. in respect of Hallmark D of D.A.C.6.

Hallmark D is based on the Model Mandatory Disclosure Rule (“M.M.D.R.”) proposed by the O.E.C.D. It covers arrangements designed to circumvent the common reporting standard (“C.R.S.”) and arrangements intended to disguise beneficial ownership.

In March 2021, the U.K. government announced that it would replace D.A.C.6 with new rules implementing the M.M.D.R. In November 2021, H.M.R.C. published a public consultation on the design of new rules to replace D.A.C.6. The consultation closed on February 8, 2022 and it is currently expected that the U.K. will introduce legislation in the summer of 2022 to replace D.A.C. 6. with new disclosure rules based on the M.M.D.R. Broadly, the new rules will require a disclosure to be made where there is an aggressive cross-border tax arrangement that seeks to circumvent the C.R.S. or avoid tax using opaque offshore structures.

### **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.

In brief, once an A.P.N. is issued, a taxpayer has 90 days to pay the tax, unless they successfully make representations to H.M.R.C. that the notice should not have been issued. However, representations can be made only on the grounds that the statutory conditions for the notice to be issued were not fulfilled. Examples are (i) the scheme was not a D.O.T.A.S. scheme, and for that reason, should not have been notified under the D.O.T.A.S. regime and (ii) the amount claimed in the A.P.N. is incorrect. There is no right of appeal against an A.P.N. Advance payments will be repaid to the taxpayer with interest in the event that the scheme is ultimately proven to be legitimate.

The introduction of the A.P.N. regime has proved controversial, and the validity of a number of A.P.N.’s has been challenged by judicial review. To date, no judicial review challenge has been successful, and A.P.N.’s remains a powerful tool in H.M.R.C.’s crusade against tax avoidance.

### **Follower Notices**

Alongside A.P.N.’s, Finance Act 2014 introduced the power for H.M.R.C. to issue Follower Notices (“F.N.’s”), which are aimed at marketed tax avoidance schemes where H.M.R.C. has already succeeded in the courts against one scheme user.

H.M.R.C. can issue an F.N. to a taxpayer when a final judicial ruling has been reached in relation to a tax avoidance scheme and H.M.R.C. considers that the

principles in the ruling can be applied to deny the tax advantage being claimed by another taxpayer. A final judicial ruling is one that cannot be further appealed.

An F.N. may require the taxpayer to amend its return, if the return is still under examination, or enter into an agreement with H.M.R.C. to settle the dispute, where the taxpayer is appealing a tax assessment. The taxpayer is also required to give H.M.R.C. notice that it has taken the necessary corrective action and notifying H.M.R.C. of the amount of additional tax that has become payable as a result. The taxpayer has 90 days in which to comply.

## **Notification of Uncertain Tax Treatments**

### **Background to the Rules**

With effect from April 1, 2022, large businesses are required to notify H.M.R.C. where they have adopted an “uncertain tax treatment.” Legislation included in the U.K.’s Finance Act 2022 introduced new rules to ensure that H.M.R.C. becomes aware at an earlier stage if a large business has adopted a tax treatment that is contrary to H.M.R.C.’s known position.

The intention to introduce new rules of this nature was first announced in the U.K.’s Budget in March 2020 (with implementation expected in April 2021). The original proposals envisaged a very broad set of notification requirements (for example, to cover a fact pattern where business *believed* that H.M.R.C. may not agree with its interpretation of tax legislation). However, following extensive consultation and a delay to implementation, the scope of the new rules has been significantly narrowed. H.M.R.C has confirmed that the U.K. government remains committed to considering whether to extend the scope of the rules further to include a requirement to notify where there is a substantial possibility that a tribunal or court would find the taxpayer’s position to be incorrect in material respects.

### **The Meaning of “Uncertain Tax Treatment”**

Broadly, an “uncertain tax treatment” will be defined by reference to two criteria:

- Whether a provision has been made in the business’s accounts for the uncertainty (to reflect the possibility that a different tax treatment will be applied to a transaction); and/or
- Whether the tax position taken by the business (either wholly or in part) is contrary to H.M.R.C.’s known interpretation or application of the relevant law, as stated in the public domain or in previous dealings with H.M.R.C.

There is a minimum threshold for the new rules to apply. Broadly, a tax treatment will only be “uncertain” if it, and any related uncertain amounts, result in a difference of more than £5 million between the business’s calculation of its tax liability and H.M.R.C.’s calculation of its tax liability.

Broadly, two uncertain tax amounts are “related” if

- both amounts are included in the same return, or a return for the same tax in the same financial or accounting period,

- both amounts relate to the same tax, and
- the tax treatment applied in arriving at one amount is substantially the same as the tax treatment applied in arriving at the other amount.

### *The Requirement to Notify*

The notification requirements only apply to “uncertain amounts” in respect to a liability for corporate income tax, income tax (including employment income tax), or V.A.T.

Broadly, a business is not required to notify H.M.R.C about an amount if it is reasonable for the business to conclude that H.M.R.C already has available to them all, or substantially all, of the information relating to that amount that they would be required to provide in the notification to H.M.R.C.

A notification is not required where a separate notification has already been made under D.O.T.A.S. or the M.M.D.R. (as discussed above).

H.M.R.C.’s position on a matter is taken to be “known” if it is apparent from published guidance, statements, or other H.M.R.C. material that is of general application and in the public domain, or through dealings with H.M.R.C. by or in respect of the business, whether or not they concern the amount in question, or the transaction to which the amount relates.

The new rules only apply to large businesses (including companies, partnerships, and limited liability partnerships). A large business is one with a U.K. turnover above £200 million and/or a U.K. balance sheet total over £2 billion. If one of these thresholds is met, the new rules will apply irrespective of whether the business is incorporated or formed in the U.K. Collective investment schemes are excluded from the new regime.

### *Penalties for Noncompliance*

An initial failure to report an uncertain tax treatment will give rise to a penalty of £5,000. A second failure to report within three years of the first failure will give rise to a further penalty of £25,000. Any subsequent failure in the same three-year period in relation to the same tax will give rise to an additional penalty of £50,000. A business will be able to appeal a penalty and attempt to rely on a defense of there being a “reasonable excuse” for failure to notify.

## **CORPORATE CRIMINAL OFFENSES OF FAILING TO PREVENT THE FACILITATION OF TAX EVASION**

### **Background to the Offenses**

On September 30, 2017, the Criminal Finances Act 2017 introduced two corporate criminal offenses (“C.C.O.’s”) of failing to prevent the facilitation of tax evasion, whereby a business will be held criminally liable if it fails to prevent its employees or any person associated with it from facilitating tax evasion.



## **The Offenses**

The legislation creates two offenses. The first offense applies to all businesses, wherever located, in respect to the facilitation of U.K. tax evasion. The second offense applies to businesses with a U.K. connection in respect to the facilitation of non-U.K. tax evasion.

The C.C.O.'s apply to both companies and partnerships. The offenses effectively make a business vicariously liable for the criminal acts of its employees and other persons "associated" with it, even if the senior management of the business was not involved or aware of what was going on.

There are two requirements for the C.C.O.'s to apply:

- Criminal tax evasion (and not tax avoidance) must have taken place.
- A person or entity who is associated with the business must have criminally facilitated the tax evasion while performing services for that business.

Associated persons are employees, agents, and other persons who perform services for or on behalf of the business, such as contractors, suppliers, agents, and intermediaries.

For either of the offenses to apply, the employee or other associated person must have criminally facilitated the tax evasion in its capacity as an employee or associated person providing services to the business. A company cannot be criminally liable for failing to prevent the facilitation of tax evasion if the facilitator was acting in a personal capacity.

## **Reasonable Prevention Procedures**

A company will have a defense against criminal liability if it can prove that it had put in place reasonable procedures to prevent the facilitation of tax evasion from taking place, or that it was not reasonable under the circumstances to expect there to be procedures in place. H.M.R.C. has published guidance on the offenses in which it explains that there are six guiding principles that underpin the defense of having reasonable prevention procedures:

- Risk assessment
- Proportionality of risk-based prevention procedures
- Top level commitment
- Due diligence
- Communication, including training
- Monitoring and review

A company must undertake a risk assessment to identify the risks of facilitation of tax evasion within the organization and the potential gaps in the existing control environment. The risk assessment should be documented so that it can provide an audit trail to support policy decisions regarding the implementation of new procedures to reduce the risk of exposure to the C.C.O.'s.

It is expected that following a risk assessment, most companies will introduce changes to ensure that they have robust procedures in place to prevent their employees, service providers, agents, suppliers, and customers from engaging in or facilitating tax evasion.

Securing top level commitment from a company's board and/or senior executives will be important in mitigating the risks of exposure to the C.C.O.'s and implementation of a policy in responses to the offenses is vital. Companies will need to adopt training programs on anti-facilitation of tax evasion and the C.C.O.'s and the programs should be available to all staff to accord with best practices.

### **Territoriality**

There are two separate offenses that apply where U.K. or non-U.K. tax is evaded. In relation to U.K. tax, the offense will apply to any company or partnership, wherever it is formed or operates. Where non-U.K. tax is evaded, a business will have committed an offense if the facilitation involves (i) a U.K. company or partnership, (ii) any company or partnership with a place of business in the U.K., including a branch, or (iii) if any part of the facilitation takes place in the U.K. In addition, the foreign tax evasion and facilitation must amount to an offense in the local jurisdiction and involve conduct that a U.K. court would consider to be dishonest.

### **Distinguishing Between Tax Avoidance and Tax Evasion**

As noted above, the C.C.O.'s will only apply when there has been fraudulent tax evasion. Fraudulent tax evasion is a crime and involves dishonest behavior. A person behaves dishonestly if he or she is aware of, or turns a "blind eye" to, his or her liability to pay tax but decides not to pay or declare the tax. Dishonest behavior may involve a person simply deciding not to declare income. It may involve someone deliberately trying to hide or misrepresent the source of money. In most countries, such dishonest tax evasion is considered illegal and therefore a crime.

Fraudulent tax evasion does not arise where a person makes a mistake or is careless. It also does not arise where a person actively seeks to avoid tax. A person's attempts to avoid tax may involve using complicated and artificial structures to exploit gaps in the rules of the tax system. Tax avoidance will usually involve arrangements to move assets from one place to another to secure a better tax treatment. Tax authorities may not agree that what has been done is legally effective and may challenge the taxpayer.

Even if the tax authority successfully challenges a tax avoidance arrangement and the taxpayer is required to pay additional tax, the taxpayer will not have acted dishonestly if a reasonable belief is held that the tax was not due when the arrangement was entered, even though a taxpayer understands that the belief may be proven wrong. Tax avoidance becomes evasion only where the taxpayer dishonestly withheld or misrepresented information to try to make the planning appear effective when it is not in fact effective.

In relation to the C.C.O.'s, the facilitator must also have a criminal intent and thus be an accomplice. At its simplest, this will occur where the facilitator knows that he is helping another person to carry out fraud. Unwitting facilitation of tax evasion is not enough, nor would knowing facilitation of tax avoidance be enough.

## F.A.T.C.A. – U.K. IMPLICATIONS

### **Background to Domestic Implementation**

The U.S. government introduced the Foreign Account Tax Compliance Act as part of the Hiring Incentives to Restore Employment Act of 2010. F.A.T.C.A.'s primary function is to require financial institutions ("F.I.'s") outside the U.S. to report information on U.S. account holders to the I.R.S. The associated penalty for noncompliance is the "big stick" of a 30% U.S. withholding tax on certain income and principal payments to recalcitrant F.I.'s by all persons, even those unrelated to the U.S. account in issue.

In the U.K., concerns were raised by the financial sector about the legal difficulties in complying with F.A.T.C.A. reporting. Particularly, F.I.'s foresaw issues with respect to U.K. data protection laws and a subsequent negative impact on the competitiveness of U.K. financial institutions ("U.K.F.I.'s") as a result of withholding on U.S.-source payments.

In response, the U.K. government, along with the governments of France, Germany, Italy, and Spain, entered into discussions with the U.S. to address the implementation of F.A.T.C.A. These discussions resulted in the publication of a joint statement on February 8, 2012, which set out an agreement to explore an intergovernmental approach, and the Model Intergovernmental Agreement to Improve Tax Compliance to Implement F.A.T.C.A. on July 26, 2012. This model has become the norm for U.S. agreements with other jurisdictions worldwide.

The U.K. then moved to enter into a bilateral intergovernmental agreement ("I.G.A.") based on this Model Agreement, and an I.G.A. 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,<sup>8</sup> which give effect to the U.K.-U.S. I.G.A., came into force on September 1, 2013. Any expression that is defined in the U.K.-U.S. I.G.A. but not in the F.A.T.C.A. regulations published by the I.R.S. is treated as having the same definition as in the I.G.A.

### **Implications of the I.G.A.**

The U.K.-U.S. I.G.A. has resulted in the following actions:

- 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.

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<sup>8</sup> SI 2013/1962.





- There will be a wider category of effectively exempt institutions and products.
- There will be an element of reciprocity so that the U.K. receives information from the U.S.

For F.I.'s in the U.K., compliance with the U.S. Internal Revenue Code is intended to be superseded by equivalent obligations under the U.K. I.G.A. and its implementing legislation. The U.K. is responsible for enforcement of these obligations, in the first instance. Failure to comply with the U.K. rules will result in having to comply with the primary F.A.T.C.A. legislation in order to avoid withholding.

F.A.T.C.A. is particularly complex and its exact application can be uncertain. Most F.I.'s demand information regarding the U.S. or non-U.S. status of all customers or customers having accounts in excess of a certain amount. Where a U.K. holding company may be obliged to comply with F.A.T.C.A. as implemented in the U.K., information on the U.S. status of substantial holders must be provided to the U.K.F.I.

## THE COMMON REPORTING STANDARD

### **Background**

The Common Reporting Standard ("C.R.S.") was developed by the O.E.C.D. and provides a mechanism for countries to automatically exchange tax information. Specifically, the C.R.S. allows countries to obtain information from resident F.I.'s and automatically exchange that information with other countries.

The C.R.S. has been incorporated into U.K. law by the International Tax Compliance Regulations 2015. Reporting under the C.R.S. was introduced in 2016, with different countries adopting the regime at different times.

The U.K. was one of 56 jurisdictions that were "early adopters" of the C.R.S. and undertook to adopt reporting requirements from January 1, 2016. U.K.F.I.'s were required to commence reporting of specified information to H.M.R.C. by May 31, 2017. H.M.R.C. then committed to exchange the relevant information with participating jurisdictions by September 30, 2017. The 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, a notable exclusion to the list of participating countries is the U.S. However, the reason for the U.S. exclusion is that F.A.T.C.A. already exists as a mechanism for identifying assets held offshore by U.S. citizens and U.S.-resident individuals.

Under the C.R.S., an entity that is an F.I. must carry out due diligence on its "account holders" – generally, persons who have debt or equity interests in that F.I. A wide variety of entities can constitute F.I.'s that are subject to reporting obligations, including banks, companies, and trusts. Entities that are not F.I.'s may be required to undertake certain due diligence procedures in support of self-certification obligations to F.I.'s.

F.I.'s report the collected information to the tax authority in their home jurisdiction. If any of those reported account holders are tax resident in another jurisdiction that has signed up to the C.R.S., the information covering the account holder will be

forwarded to the relevant jurisdiction not later than nine months after the end of the calendar year on which the report is made.

The C.R.S. was modeled on and closely follows F.A.T.C.A., although the two regimes differ in certain respects. Given that the U.S. has not committed to exchange information under the C.R.S., F.A.T.C.A. arrangements under the U.K.-U.S. I.G.A 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.

## **THE IMPACT OF THE COVID-19 PANDEMIC**

The U.K. government introduced several temporary tax measures in response to the COVID-19 pandemic that swept across the world over the course of 2020 and 2021.

### **V.A.T. Deferral and Reduction**

A V.A.T. tax deferral was introduced whereby, businesses did not have to make V.A.T. payments due in the period from March 20 until June 30, 2020. Initially, affected businesses were given until March 31, 2021 to pay any liabilities that had accumulated during the deferral period. Deferred amounts are not subject to interest or penalties. A business could defer only the following:

- Quarterly and monthly V.A.T. return payments for the periods ending in February, March, and April 2020
- Payments on account due between March 20 and June 30, 2020
- Annual accounting advance payments due between March 20 and June 30, 2020

The deferral was available to all businesses, regardless of size and it applied automatically, so businesses did not have to apply for it. V.A.T. returns needed to be submitted on time. In February 2021, H.M.R.C. announced the introduction of a new

*“Different jurisdictions may operate different penalty systems for noncompliance.”*

payment scheme into which businesses that had deferred V.A.T. payments could elect. The scheme enabled affected businesses to pay deferred V.A.T. in smaller Installments and was open from February 23, 2021 until June 21, 2021.

To support jobs in the hospitality and tourism sectors, the U.K. government announced on July 8, 2020, that from July 15, 2020, a temporary cut in V.A.T. from 20% to 5% would apply on (i) food and non-alcoholic drinks from restaurants, pubs, bars, cafes and similar premises and (ii) accommodation and admission to tourist attractions across the U.K. The temporary reduction was originally due to end on January 12, 2021. In September 2020, the reduction was extended until March 31, 2021. At the U.K.'s Budget in March 2021, the government announced that the reduced rate would be extended for a further period until September 30, 2021, and that a new temporary reduced rate of 12.5% would then be introduced until March 31, 2022.

### **Deferred Tax Payments**

Businesses that could not afford to pay tax bills as a result of the COVID-19 pandemic could approach H.M.R.C. to see if they would agree to a "time to pay" agreement which would suspend debt collection. H.M.R.C. set up a dedicated helpline to support businesses that were concerned about not being able to pay their tax due to the COVID-19 pandemic.

### **Job Retentions Scheme**

To support employers and employees, the U.K.'s Coronavirus Job Retention Scheme was introduced which, subject to conditions, enabled employers to claim a grant from H.M.R.C. to cover 80% of the wages (subject to a maximum of £2,500 a month) of their workforce who remained on payroll but who were temporarily not working (or furloughed) during the coronavirus outbreak. The scheme was initially due to end on October 31, 2020 but was extended several times and finally ended on September 30, 2021. From July 2021, while furloughed individuals continued to be entitled to receive 80% of their wages (subject to a maximum of £2,500 a month) the government reduced its contribution to 70% and employers were required to pay the remaining 10%. From August 2021, the government's contribution was reduced further to 60%, with employers contributing the remaining 20%.

### **Stranded Individuals**

The limitations on international travel during the COVID-19 pandemic may also have affected an individual's status for U.K. tax residence purposes.

As discussed earlier in this chapter, the U.K.'s statutory residence test determines whether an individual is U.K. tax resident. One of the factors relevant to determining tax residence is the number of days that an individual spends in the U.K. It is currently possible to exclude a maximum of 60 days spent in the U.K. in any tax year as a result of exceptional circumstances.

H.M.R.C. issued guidance on when COVID-19 may result in exceptional circumstances for these purposes. The guidance said that whether days spent in the U.K. could be disregarded due to exceptional circumstances would always depend on the facts and circumstances of each individual case. However, the guidance confirmed that the circumstances would only be considered as exceptional when any of the following fact patterns exist for the individual:

- The individual is quarantined or advised by a health professional or public health guidance to self-isolate in the U.K. as a result of the virus.
- The individual is advised by official government advice not to travel from the U.K. as a result of the virus.
- The individual is unable to leave the U.K. as a result of the closure of international borders.
- The individual is asked by the employer to return to the U.K. temporarily as a result of the virus.

The O.E.C.D. issued guidance on how it considers that international tax treaties should be interpreted in the light of the coronavirus pandemic. It expresses the view that the residence of an individual should not change when an individual is stranded for a period in a country that is not the country of residence due to travel restrictions and quarantine measures.

### **Corporate Tax Residence and Permanent Establishments**

In relation to U.K. corporate residence for tax purposes and permanent establishments, H.M.R.C.'s coronavirus guidance states that existing U.K. legislation and guidance already provides flexibility to deal with changes in business activities necessitated by the response to the pandemic. The guidance confirms that H.M.R.C. does not consider that a company will necessarily become U.K. tax resident because a few board meetings are held in the U.K. or because some decisions are taken in the U.K. over a short period of time. H.M.R.C. will "take a holistic view of the facts and circumstances of each case." H.M.R.C. also confirms that a nonresident U.K. company will not automatically have a U.K. taxable presence when U.K. activities occur over a short period of time.



## BELGIUM

**Author**  
Werner Heyvaert  
AKD Benelux Lawyers  
Brussels

Over the last decades, Belgium has become a competitive player in the international tax arena. Despite a relatively high corporate income tax (“C.I.T.”) rate of 25% in comparison with other E.U. jurisdictions, Belgium offers a wide-range of tax-planning opportunities for Belgian holding companies and Belgian branches of foreign companies.<sup>1</sup>

These opportunities include, but are not limited to, the following:

- The participation exemption, also referred to as the dividend received deduction (“D.R.D.”),<sup>2</sup> which fully exempts from C.I.T. dividends received from qualifying subsidiaries and capital gains realized on the shares of qualifying subsidiaries
- The innovation income deduction (“I.I.D.”), which allows a deduction of 85% of qualifying innovation income determined in accordance with the O.E.C.D.’s nexus rules<sup>3</sup>
- The ruling practice, which allows taxpayers to obtain a binding opinion from the Belgian Tax Ruling Committee on tax issues and the Belgian Accounting Standards Committee on accounting issues
- The absence of capital tax and of a net wealth tax
- The deductibility of finance costs
- The extensive Belgian tax treaty network
- The application of the E.U. Parent-Subsidiary Directive (“P.S.D.”) to all tax treaty countries

The author acknowledges the contribution of his colleague Vicky Sheikh Mohammad.

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<sup>1</sup> The Belgian branch of a foreign company can be a valuable alternative to a Belgian company because, *inter alia*, there is no dividend withholding tax (“W.H.T.”) or “branch profits tax” due on the repatriation of branch income to the head office. In most instances, however, foreign investors operate in Belgium through a subsidiary that adopts a corporate form rather than a branch. Although several corporate forms exist under Belgian corporate law, the most commonly used are the Public Limited Liability Company (S.A./N.V.) and the Limited Liability Company (S.R.L./B.V.). From a Belgian tax perspective, both the S.A./N.V. and the S.R.L./B.V. are subject to identical C.I.T. rules. The use of non-corporate entities, such as partnerships, is relatively limited.

<sup>2</sup> D.R.D. stands for *revenus définitivement taxés* or R.D.T. in French and *definitief belaste inkomsten* or D.B.I. in Dutch.

<sup>3</sup> The I.I.D. can be combined with another Belgian tax incentive that is the 80% wage W.H.T. exemption for qualifying scientific workers.

This chapter examines the relevant tax aspects for multinationals doing business or planning to do business with or through Belgian holding companies. Where relevant, recent amendments to Belgian tax law are also discussed. With a statute of limitation of at least three years, historic rules remain relevant in case of a tax audit covering previous years.<sup>4</sup>

## CORPORATE INCOME TAX

### **General Regime**

Companies are subject to Belgian C.I.T. if all of the following three conditions are met:<sup>5</sup>

- They have a separate legal personality under Belgian or foreign corporate law or, if the governing foreign corporate law does not confer legal personality, they have a legal form that is comparable to a legal form that has legal personality under Belgian corporate law.
- They carry on a business or are engaged in profit-making activities.
- They have their effective place of management or control in Belgium.<sup>6</sup>

Companies are subject to Belgian C.I.T. on their worldwide profit, including distributed dividends. The taxable income is determined on the basis of the commercial accounts and the accounting rules, unless the tax laws provide otherwise.<sup>7</sup>

Companies must use their standalone Belgian G.A.A.P. accounts to prepare their C.I.T. return; accounts prepared using I.A.S. or I.F.R.S. cannot be utilized for Belgian C.I.T. purposes.

### **Corporate Income Tax Rate**

Following a major overhaul of Belgium's C.I.T. in 2017, the standard C.I.T. rate is 25%.<sup>8</sup>

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<sup>4</sup> In the event of alleged fraud, the statute of limitation is extended to seven years. In some circumstances, the statute of limitation is even longer; this is the case, for example, when the Belgian tax authorities receive information from foreign tax authorities.

<sup>5</sup> Article 179 of the Belgian Income Tax Code ("I.T.C."), read in parallel with Article 2, ¶1, 5°, a) and b) I.T.C.

<sup>6</sup> Although Belgian corporate law recently switched to the "statutory seat" doctrine, Belgian tax law still applies the "real seat" doctrine. When a company has its statutory seat in Belgium, it is presumed to have its real seat in Belgium, too. The company may rebut this presumption if it can establish that its tax residency is in another country in accordance with the tax legislation of that country. The concept of "effective place of management or control" or "real seat" refers to a factual situation. In practice, the real seat will be the place where the principal directors meet, where the shareholders' meetings are held, where the ultimate management of the company takes place and where the impulse in the company is given.

<sup>7</sup> Article 24, third limb I.T.C.

<sup>8</sup> Article 215 I.T.C.

Companies may benefit from a reduced rate of 20% for the first €100,000 of taxable income if all of the following conditions are met:<sup>9</sup>

- It qualifies as a small- or medium-sized enterprise (“S.M.E.”) within the meaning of the Belgian Companies as Associations Code (“B.C.A.C.”). The B.C.A.C. defines S.M.E.’s as companies which, on the balance sheet of the last two financial years, do not exceed more than one of the following criteria:<sup>10</sup>
  - i. An annual average of 50 employees
  - ii. Annual sales of €9 million, excluding V.A.T.
  - iii. A balance sheet total of €4.5 million
- At least 50% of the company’s shares are held by individuals.<sup>11</sup>
- It pays, from the fifth taxable period following its establishment, an annual compensation of €45,000 or more to at least one manager of the company that is a natural person. The annual compensation can be lower if it is at least equal to the company’s taxable income.<sup>12</sup>
- It is not an investment company.<sup>13</sup>
- It does not hold participations in one or more other companies that have a combined acquisition value that exceeds 50% of either the revalued paid-up capital of the company or the paid-up capital, taxed reserves, and recorded capital gains of the company. Participations of at least 75% are excluded from this calculation.<sup>14</sup>

Most Belgian holding companies will not be eligible for the reduced rate because, *inter alia*, less than 50% of their shares will be held by individuals.

### **Minimum Taxable Base**

Companies with a taxable profit that exceeds €1 million cannot fully benefit from certain tax attributes such as a tax loss carryforward or a D.R.D. carryforward. In the profitable year, the benefit is capped at 70% of the taxable profits in excess of €1 million.<sup>15</sup> As a result, 30% of the taxable profits that exceed €1 million in the carry-forward year will remain taxable. The unused tax attributes can be carried forward to following taxable years until finally used. Belgian holding companies will, therefore, need to re-assess their use of tax attributes and their recognition of related deferred tax assets.

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<sup>9</sup> Article 215, second limb I.T.C.

<sup>10</sup> Article 1:24 B.C.A.C.

<sup>11</sup> Article 215, third limb, 2° I.T.C.

<sup>12</sup> Article 215, third limb, 4° I.T.C.

<sup>13</sup> Article 215, third limb, 6° I.T.C.

<sup>14</sup> Article 215, third limb, 1° I.T.C.

<sup>15</sup> See Article 207, fifth limb I.T.C.

## Taxation of Dividends Received

### In General

Dividends received by a Belgian company are in principle subject to the standard 25% C.I.T. rate or the reduced rate of 20% for the first €100,000 of taxable income, if applicable.

### Participation Exemption

By way of exception, dividends received by a Belgian company may be fully exempt under the D.R.D. regime if all of the following conditions are met:

- **Minimum Participation Value:** The recipient company owns at least 10% of the nominal share capital<sup>16</sup> of the subsidiary making the payment *or* the acquisition value of its holdings in the subsidiary is at least €2.5 million.<sup>17</sup>
- **Minimum Holding Period:** The recipient holds (or has committed to hold) the minimum participation referred to in the previous bullet in full ownership<sup>18</sup> for an uninterrupted period of at least one year prior to (and/or following) the dividend distribution.<sup>19</sup>
- **Subject to Comparable Tax Test:** The subsidiary making the dividend payment is subject to Belgian C.I.T. or a foreign tax similar to Belgian C.I.T.<sup>20</sup>

A foreign tax is not considered similar if the nominal or effective rate of tax is below 15%. The taxpayer may rebut this presumption.<sup>21</sup>

Tax regimes of all E.U. jurisdictions are deemed to be similar to Belgian C.I.T. even if the nominal or effective tax rate is below 15%.<sup>22</sup> Examples of countries benefiting from this rule are Ireland and Cyprus.



<sup>16</sup> Under the B.C.A.C., the concept of “capital” has ceased to exist for the S.R.L./B.V. and is replaced by the concept of “equity.” Equity consists of (i) the contributions of shareholders (formerly labeled “share capital”), (ii) reserves (retained earnings), and (iii) income (profit) carried forward that serves as protection for creditors (formerly labeled “legal reserve”). For the S.A./N.V., the terminology “capital” remains applicable.

<sup>17</sup> Article 202, ¶2, first limb, 1° I.T.C.

<sup>18</sup> A *usufruct* right over the shares does not suffice. A *usufruct* right arises when full legal ownership to an asset is divided between bare legal ownership (a capital or remainder interest) and ownership of a current right to income or use. The latter is the *usufruct* right. The right exists for a limited period of time and is separate from the capital interest.

<sup>19</sup> Article 202, ¶2, first limb, 2° I.T.C.

<sup>20</sup> Article 203, ¶1, first limb, 1° I.T.C.

<sup>21</sup> Article 203, ¶1, second limb I.T.C.

<sup>22</sup> Article 203, ¶1, third limb I.T.C.



In contrast, countries appearing on the E.U. list of noncooperative jurisdictions will be deemed to not have a tax regime similar to Belgian C.I.T.<sup>23</sup> This list includes the following jurisdictions: American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, the U.S. Virgin Islands, and Vanuatu.

Likewise, the Royal Decree implementing the I.T.C. (“R.D./I.T.C.”) contains a list of 31 jurisdictions that are presumed to not have a tax regime similar to Belgian C.I.T.<sup>24</sup> Currently, this list includes the following jurisdictions:

Abu Dhabi	Maldives
Ajman	Marshall Islands
Andorra	Micronesia
Bosnia & Herzegovina	Moldova
Dubai	Monaco
East Timor	Montenegro
Gibraltar	Oman
Guernsey	Paraguay
Isle of Man	Qatar
Jersey	Ras al Khaimah
Kosovo	Serbia
Kuwait	Sharjah
Kyrgyzstan	Turkmenistan
Liechtenstein	Umm al Qaiwain
Macau	Uzbekistan
Macedonia	

Countries appearing on this R.D./I.T.C. list may still pass the subject-to-tax test if the taxpayer is able to rebut the presumption. For example, due to the recent increase of the C.I.T. rate to 15% in Serbia, taxpayers may argue that Serbian-source dividends qualify for the D.R.D. despite appearing on the list.<sup>25</sup>

- **Specific Anti-Abuse Rule:** The D.R.D. is not available for dividends stemming from a company that distributes income related to a legal act or a series of legal acts that the Belgian tax authorities have determined are not genuine, and have as their main goal or one of their main goals the attainment of the deduction or one of the benefits of the P.S.D. in another E.U. Member State.<sup>26</sup> The determination is to be based on all relevant facts, circumstances, and proof to the contrary. Actions will be considered “not genuine” if they are not taken for valid commercial reasons that reflect economic reality. This rule is separate from Belgium’s general anti-abuse provision.

<sup>23</sup> Article 203, ¶1, first limb, 1°, *in fine*; See “Annex I – E.U. list of non-cooperative jurisdiction for tax purposes” to the E.U.’s Council conclusions on the revised EU list of noncooperative jurisdictions for tax purposes, O.J., 2022/C 103/01, March 3, 2022.

<sup>24</sup> Article 734<sup>quater</sup> R.D./I.T.C.

<sup>25</sup> See Ruling No. 2016.740 of November 29, 2016, available [here](#).

<sup>26</sup> Article 203, ¶1, first limb, 7° I.T.C.

## Exceptions to the Participation Exemption

### Finance, Treasury and Investment Companies

The D.R.D. is not available for dividends distributed by a finance company, a treasury company or an investment company where the company enjoys a tax regime that deviates from the normal tax regime in its country of residence.<sup>27</sup>

A company is a finance company if its sole or principal activity consists of providing financial services to unrelated parties (*i.e.*, parties that do not form part of a group to which the finance company belongs).<sup>28</sup> Financial services include the provisions of financing and financial management. Belgian companies are part of the same group if one company exercises control over the others, if two companies are controlled by a common parent company, or if they constitute a consortium.<sup>29</sup>

A treasury company is a company that is principally engaged in portfolio investment other than cash pooling.<sup>30</sup>

An investment company is a company whose purpose is the collective investment of capital funds. Examples are companies that qualify as S.I.C.A.V.'s or S.I.C.A.F.'s.<sup>31</sup>

Nonetheless, the D.R.D. is available under certain conditions for E.U.-based finance companies and for investment companies.<sup>32</sup>

### Regulated Real Estate Companies

The D.R.D. is not available for dividends derived from a Belgian regulated real estate company, which is the functional equivalent of a real estate investment trust ("R.E.I.T.").<sup>33</sup> The same rule applies to a nonresident company if all of the following conditions are met:

- The main purpose of the company is to acquire or construct real estate property and make it available on the market, or to hold participations in entities with a similar purpose.
- The company is required to distribute part of its income to its shareholders.
- The company benefits from a regime that deviates from the normal tax regime in its country of residence.

### Offshore Activities

The D.R.D. is not available for dividends distributed by a company when the non-dividend income of that company originates in a third country and such income

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<sup>27</sup> Article 203, ¶1, first limb, 2° I.T.C.

<sup>28</sup> Article 2, ¶1, 5°, d) I.T.C.

<sup>29</sup> See Article 2, ¶1, 5°/1, which refers to Article 1:20 B.C.A.C.

<sup>30</sup> Article 2, ¶1, 5°, e) I.T.C.

<sup>31</sup> Article 2, ¶1, 5°, f) I.T.C.

<sup>32</sup> See Article 203, ¶2 I.T.C.

<sup>33</sup> Article 203, ¶1, first limb, 2°*bis* I.T.C.; For further details on the tax regime of Belgian Regulated Real Estate Companies, see P. Desenfans et L. Pinte, "Aspects fiscaux des SIR et FIIS," *Jurim pratique*, 2017/3, pp. 189-221.

is subject to a separate tax regime that provides more favorable results than the regular tax regime.<sup>34</sup>

### Certain Foreign Branch Income

The D.R.D. is not available when the dividends are distributed by a company that realizes profits through a foreign branch that is subject to a tax regime substantially more advantageous than in Belgium.<sup>35</sup> This disallowance rule is, in turn, subject to an exception. The D.R.D. will be allowed for dividends distributed by (i) Belgian companies with foreign branches or (ii) companies established in certain treaty jurisdictions and that operate through a branch in a third country.

Dividends stemming from non-Belgian branch profits qualify for the D.R.D. to the extent that either the branch profits are subject to a 15% foreign income tax, or the branch is located in another E.U. jurisdiction.<sup>36</sup>

### Intermediate Companies

Subject to a 10% *de minimis* rule, the D.R.D. is not available for dividends distributed by an intermediate company, other than an investment company, that redistributes dividend income derived from tainted participations.<sup>37</sup> As a result, if more than 10% of a dividend received from an intermediate company is funded by the receipt of dividends from its subsidiaries located in third countries, the D.R.D. may be disallowed if the D.R.D. would not have been permitted had the lower-tier companies paid dividends directly to the Belgian company. In other words, a group cannot cleanse tainted dividends by washing them through an intermediary located in an “acceptable” jurisdiction.

As a safe harbor, participations in companies (i) residing in a country with which Belgium has concluded an income tax treaty or (ii) that are listed on a recognized E.U. stock exchange are in principle eligible for the D.R.D.<sup>38</sup> These companies must also be subject to a tax regime comparable to the Belgian tax regime, without benefiting from a regime that deviates from the normal tax regime.<sup>39</sup>

With respect to investments in a second-tier subsidiary through a hybrid entity such as a U.S. limited liability company (“L.L.C.”), the Belgian Ruling Committee issued several favorable rulings. In most instances, the Ruling Committee confirmed that, for Belgian tax purposes, one can look through a foreign hybrid entity to allow the D.R.D. as if the underlying participation in a lower-tier company were held directly by the Belgian holding company. Thus, for example, in a ruling dated February 12, 2019, the Ruling Committee found that a Belgian company was entitled to the D.R.D. with respect to dividends received from a U.S. L.L.C.<sup>40</sup> The Ruling Committee looked to paragraph 1(b) of Article 22 (Relief From Double Taxation) of the Belgium-U.S. Income Tax Treaty and ruled that the Belgian company was entitled

<sup>34</sup> Article 203, ¶1, first limb, 3° I.T.C.

<sup>35</sup> Article 203, ¶1, first limb, 4° I.T.C.

<sup>36</sup> Article 203, ¶2, seventh limb I.T.C.

<sup>37</sup> Article 203, ¶1, first limb, 5° I.T.C.

<sup>38</sup> Article 203, ¶2, eighth limb, 1° I.T.C.

<sup>39</sup> Article 203, ¶3 I.T.C.

<sup>40</sup> Ruling No. 2018.0085 of February 12, 2019, available [here](#).

***“Dividends stemming from non-Belgian branch profits qualify for the D.R.D. to the extent that either the branch profits are subject to a 15% foreign income tax, or the branch is located in another E.U. jurisdiction.”***

to the D.R.D. to the extent that such dividends stemmed from dividends received by the L.L.C. from a U.S. operating corporation that was subject to full corporate income tax in the U.S.

In the same ruling, the Ruling Committee confirmed that the proceeds of a redemption of capital that is received by an L.L.C. and in turn distributed to a Belgian company was plainly exempt from Belgian C.I.T. by virtue of Article 18, second limb, I.T.C. when the underlying U.S. company owned by the L.L.C. is subject to full tax in the U.S. Article 18 I.T.C. defines the term “dividend.” Excluded from the scope of that definition is any return of share capital, provided the corporation that makes a distribution in return of share capital complied with the relevant company law rules. No requirement exists to test the quantitative or qualitative conditions of the D.R.D. under Belgian domestic law or an income tax treaty.<sup>41</sup>

#### Dividend Payments that are Deductible for the Payor

The D.R.D. is not applicable to dividend income received from a company that has deducted or can deduct such income from its profits.<sup>42</sup>

#### Ruling Practice

Upon a taxpayer’s request, the Belgian Ruling Committee may issue an advance tax ruling on various items such as the availability of the D.R.D., the capital gains exemption, the application of anti-abuse provisions and the qualification of a company as resident or nonresident taxpayer. Although a ruling is not mandatory, it is frequently used by multinational groups to obtain legal certainty.

In theory, the Ruling Committee issues the ruling within three months following the receipt of a complete ruling application. In practice, however, the actual term is assessed on a case-by-case basis within 15 days following the filing of the ruling application.

Subject to conditions, a ruling is valid for a maximum of five years. If justified, a ruling can be granted for a longer period. Rulings can also be renewed.

Effective May 2019, the Belgian Accounting Standards Committee issues rulings on the application of accounting law rules. In the absence of a tax rule that differs from an accounting rule, Belgian tax law follows Belgian accounting practice. The availability of accounting law rulings may prove useful in practice.

#### *Taxation of Dividends Received in a Year Having Operating Losses*

Prior to assessment year 2009, if a Belgian company’s activities other than serving as a holding company for its subsidiaries resulted in a loss in the current year, the loss was used to offset dividend income. As a result, the benefit of the loss carry-over was reduced or even completely eliminated. Moreover, the unused portion of the D.R.D. was permanently lost.

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<sup>41</sup> Note that under U.S. tax law, not all distributions that return share capital are treated as a redemption giving rise to capital gain treatment under U.S. tax law. Under Section 302 of the Internal Revenue Code, a distribution in return of capital – typically referred to as a redemption under U.S. tax jargon – is treated in some circumstances as a redemption and in others as a dividend.

<sup>42</sup> Article 203, ¶1, first limb, 5° I.T.C.

This position was challenged in an appeal to the European Court of Justice (“E.C.J.”) in *Cobelfret v. Belgium* (Case C-138/07).<sup>43</sup> On February 12, 2009, 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. P.S.D. Two other cases were decided by “reasoned order” of the E.C.J. on June 4, 2009.<sup>44</sup> These cases dealt with E.U.-source dividends, Belgian domestic dividends, and dividends from countries outside of Europe. The E.C.J. asked the national courts to decide whether discrimination existed in the treatment of nonresident taxpayers when compared with resident taxpayers. This triggered an amendment to the statute by the Law of December 21, 2009, effective January 1, 2010. The net effect is that the unused portions of the D.R.D. can be carried forward for use in future tax years only if, at the time the dividend is declared, the dividend distributing company is established in any of the following jurisdictions:

- A Member State of the European Economic Area (“E.E.A.”), including Belgium
- A country with which Belgium has concluded a tax treaty that contains an equal treatment clause (functional equivalent of Article 22(1)(c) of the Belgium-U.S. Income Tax Treaty currently in effect)
- Another country, provided that Article 63 of the Treaty on the Functioning of the European Union (“T.F.E.U.”) (free movement of capital) applies – to the capital represented by the shares that produce the dividends

Non-E.E.A. source dividends remain unaffected by the E.C.J. *Cobelfret* case. Consequently, the unused portion of the D.R.D. cannot be carried forward.<sup>45</sup>

In addition, Belgium disallows the D.R.D. to the extent that a Belgian company’s taxable income (*i.e.*, profit) reflects certain nondeductible expenses.<sup>46</sup> However, the disallowance does not apply to dividends stemming from qualifying subsidiaries established in a Member State of the E.E.A.<sup>47</sup>

Where the facts of a particular case involving dividends from a company meet none of the foregoing criteria, the law remains unfavorable for taxpayers. According to a ruling of February 1, 2011, from the Court of First Instance in Brussels,<sup>48</sup> the rule that excess dividends cannot be carried over if they stem from subsidiaries in non-E.E.A. countries with which Belgium does not have an income tax treaty in force containing an equal treatment provision does not run afoul of the Belgian constitutional non-discrimination rule.

In the facts addressed by the Brussels Court, the tax administration allowed a taxpayer to carry over excess dividends from a Japanese subsidiary of a Belgian holding company because an equal treatment provision is provided in Article 23(2)(a) of



<sup>43</sup> E.C.J., *Belgische Staat v. Cobelfret N.V.*, Case C-138/07, February 12, 2009, available [here](#).

<sup>44</sup> E.C.J., *Belgische Staat v. KBC Bank N.V. and Beleggen*, Risicokapitaal, Joined Cases C-439/07 & C-499/07, June 4, 2009, available [here](#).

<sup>45</sup> Article 205, ¶13, *a contrario* I.T.C.

<sup>46</sup> Article 205, ¶12, first limb I.T.C.

<sup>47</sup> Article 205, ¶12, second limb I.T.C.

<sup>48</sup> Court of First Instance in Brussels, February 1, 2011, R.G. 2009/1652/A, available [here](#).

the Belgium-Japan Income Tax Treaty. However, the tax administration refused to allow the carryover of Taiwanese and South Korean dividends, because the treaties with those jurisdictions did not contain an equal treatment clause. Before the Brussels Court, the taxpayer claimed that the foregoing distinction ran afoul of the Belgian nondiscrimination rule of Article 10 in conjunction with Article 172 of the Belgian Constitution. However, the Tribunal sided with the tax administration, concluding that the distinction between an E.E.A.-source dividend and a “third country dividend” is based upon an objective criterion, and for that reason, is permissible.

In a similar case decided on October 10, 2012, the Belgian Constitutional Court confirmed that the carryforward or denial of the participation exemption for excess dividends from companies organized in third countries not having bilateral tax treaties with equal treatment clauses does not constitute a violation of the constitutional nondiscrimination principle.<sup>49</sup>

In sum, the unused portion of D.R.D. for E.E.A. source dividends can be carried forward following the E.C.J.’s *Cobelfret* case discussed above. Conversely, the D.R.D. for non-E.E.A. source dividends remains subject to a double restriction:

- The D.R.D. cannot apply to certain nondeductible expenses (e.g., the nondeductible portion of restaurant expenses).<sup>50</sup>
- The unused portion of the D.R.D. cannot be carried forward.<sup>51</sup>

Say a Belgian company (“BelCo”) has (i) a non-E.E.A. source dividend of €50, (ii) a current year loss of €20, and (iii) nondeductible restaurant expenses of €10.

Before applying the D.R.D., the taxable base of BelCo is €40 (50-20+10). If the dividend of €50 meets the conditions for the D.R.D., the D.R.D. will apply only to €30 (40 of net income - 10 of nondeductible expenses), leaving a taxable base of €10 (40-30).

The unused portion of the D.R.D. (50-20 = 30) will be forfeited, as the dividend is from a non-E.E.A. source and thus cannot be carried forward, unless the dividend stems from a participation based in a country having a bilateral treaty in force with Belgium and which contains an equal treatment clause.

## **Taxation of Capital Gains on Shares**

### **Taxation of Realized Capital Gains on Shares**

Capital gains on shares realized by a Belgian company are in principle taxed as ordinary profits and subject to the standard 25% C.I.T. rate or the reduced rate of 20% for the first €100,000 of taxable income, if applicable.

By way of exception, a full exemption is applicable provided that the participation, holding period and subject-to-tax requirements applicable for the D.R.D. are met

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<sup>49</sup> Belgian Constitutional Court, October 10, 2012, R.G. 118/2012, available [here](#).

<sup>50</sup> See Article 205, ¶2, first limb I.T.C. for the complete list.

<sup>51</sup> Article 205, ¶3, *a contrario* I.T.C.

(see conditions above).<sup>52</sup> The exemption applies only to the net gain realized, *i.e.*, the amount after the deduction of the alienation costs (*e.g.*, notary fees, bank fees, commissions, publicity costs, consultancy costs, etc.).<sup>53</sup>

The fact that, as of assessment year 2019 (accounting years ending on or after December 31, 2018), the capital gain exemption is fully synchronized with the D.R.D. has important consequences in the following cases:

### The “One Taints All” Principle

Prior to assessment year 2019, capital gains on the disposal of a share package containing a tainted share (*i.e.*, a share that did not qualify for the D.R.D.) were not exempt. After the reform, it is clear that a proportional exemption is possible, similar to the rules for the D.R.D.

### Disposal of Part of a Qualifying Participation

Assume that a taxpayer has a qualifying participation of more than 10% or €2.5 million and that only a part of that participation is sold or otherwise disposed of. Any gain on this sale qualifies for the capital gain exemption.

However, it is not entirely clear whether the exemption will be available when the remainder of the participation is sold at a later time. If the remaining shareholding has an historic book value of at least €2,500,000 or constitutes a participation of at least 10%, the exemption should be available. On the other hand, if the remaining shareholding has dropped below both the 10% and the €2,500,000 thresholds, any gain on the sale of the remaining shareholding will likely fail the minimum participation test and, therefore, not be exempt.

### Exchange of Shares

Subject to certain conditions, when a Belgian company transfers shares in a Belgian or European target company to a European acquiring company in exchange for issuance of new shares of the acquiring company, any gain resulting from the share-for-share exchange is temporarily exempt under the E.U. Merger Directive. As a result, it is possible in principle to exchange tainted shares for untainted shares. After the exchange, a company could request the exemption for capital gains on shares as described above. To stop this practice, the Belgian legislature has implemented a specific anti-abuse provision limiting the exemption to the capital gains that accrue after the exchange of shares. This provision applies only to shares that do not meet the valuation standard for exemption. Why the holding and/or participation requirements are not also subject to this provision is unclear and may lead to its improper use.

### Minimum Requirements

The minimum participation requirements that exist for dividends – ownership of 10% of the capital, or an acquisition value of not less than €2.5 million – also apply to capital gains.<sup>54</sup>

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<sup>52</sup> Article 192, ¶1 I.T.C.; The minimum participation requirement does not apply to insurance and reinsurance companies that hold participations to hedge their liabilities.

<sup>53</sup> Article 43 I.T.C.

<sup>54</sup> See Article 192, ¶1 I.T.C, which refers back to Articles 202-203.

In the past, uncertainty existed regarding the D.R.D. where the shares were acquired by a Belgian holding company at a price or value that was far below their actual value at the time of acquisition. The position of the Belgian tax authorities was that the difference between the artificially low acquisition price and the high actual value as of the date of acquisition should be booked as an undervaluation of assets and taxed as regular income of the holding company. The income would be deemed to have accrued in the year of acquisition. It would be taxed retroactively at the full C.I.T. rate of 25%.

This position was successfully challenged in the *Gimle* case<sup>55</sup> in a preliminary ruling from the E.C.J. that was settled definitively by the Court of Cassation.<sup>56</sup> Going forward, the full gain based on the low purchase price is exempt.

### Operation of the Capital Gains Exemption

The capital gains exemption is granted by a direct elimination of the net gain from taxable income. Consequently, loss utilization is not adversely affected.

Losses derived from other activities of the Belgian holding company, including interest and other costs or expenses related to the acquisition of the participation, are not allocated to the exempt gain.

This treatment should be compared to the treatment of costs and expenses relating to the sale of shares. This is discussed below.

### Options

If a Belgian company purchases stock below fair market value pursuant to the exercise of a call option or a warrant, any subsequent gains realized upon the disposition of the shares of stock qualify in principle as fully exempt capital gains, provided all conditions provided in Belgian law are met. The exemption does not apply to gains derived from the sale of the option or the warrant as such. If the call option itself were sold at a gain reflecting the appreciation of the value of the underlying share, the gain would be subject to the regular C.I.T. rate.

Note, however, that the law of December 1, 2016 introduced specific anti-abuse provisions applicable to the D.R.D., the capital gains exemption, and the W.H.T. exemption for parent companies. These rules are in addition to Belgium's general anti-abuse provision. Transposing the revisions to the P.S.D. issued by the European Commission ("Commission"), taxpayers must have appropriate business motives for the implementation of a holding structure, as previously discussed.

### Taxation of Unrealized Capital Gains on Shares

Unrealized capital gains are not taxable if the capital gains are not reflected in the company's financial accounts. There are no mark-to-market rules under Belgian G.A.A.P. Even if reported, the unrealized gain is not taxable if it is booked in a non-distributable reserve account.<sup>57</sup> Upon later realization of the gain, the non-distributable

***"Going forward, the full gain based on the low purchase price is exempt."***

<sup>55</sup> E.C.J., *Belgium v. Gimle S.A.*, Case-322/12 of October 3, 2012, ECLI:EU:C:2013:632, spec. ¶39.

<sup>56</sup> Court of Cassation, May 16, 2014, R.G. F.10.0092.F., available [here](#).

<sup>57</sup> Article 24, first limb, 2° I.T.C. read in parallel with Article 44, ¶1, 1° and 190, second and fourth limbs.



reserve account disappears without triggering C.I.T., assuming all conditions for the capital gains exemption are met at that time.

### **Taxation of Realized and Unrealized Capital Losses on Shares**

Capital losses on shares, whether realized or unrealized, are not tax deductible.<sup>58</sup> However, the loss incurred in connection with the liquidation of a subsidiary company remains deductible up to the amount of lost paid-up share capital.

The nondeductibility is limited to shares. Capital losses realized on other securities (e.g., bonds) or derivatives (e.g., options) are fully tax deductible.

## **WITHHOLDING TAX ON DIVIDEND DISTRIBUTIONS**

### **To Belgium**

Dividends distributed by a non-Belgian company to a Belgian company may be subject to dividend W.H.T. at the rate in effect in the country of residence of the company paying the dividend. In most situations, this rate is reduced or eliminated by a tax treaty or the P.S.D.

With the exception of investment companies, Belgium's national law does not grant a tax credit for foreign W.H.T. imposed on dividends.<sup>59</sup> However, certain bilateral tax treaties provide a Foreign Tax Credit ("F.T.C.") trumping the Belgian national law provisions. For instance, the Belgian Court of Cassation ruled on October 15, 2020, that the Belgian tax authorities cannot invoke national provisions to deny Belgian taxpayers the benefit of the 1964 Belgium-France tax treaty.<sup>60</sup>

### **From Belgium**

#### **General Rule**

As a general rule, dividends distributed by Belgian companies to resident and non-resident shareholders are subject to 30% Belgian dividend W.H.T.<sup>61</sup> Under specific circumstances, reduced rates or exemptions are available.

A full exemption of Belgian dividend W.H.T. applies on the payment of dividends to a parent company established within the E.E.A. (including Belgium) or in a country with which Belgium has concluded a tax treaty containing an exchange of information

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<sup>58</sup> Article 198, ¶1, 7° I.T.C.

<sup>59</sup> Article 285, second limb I.T.C.

<sup>60</sup> Court of Cassation, October 15, 2020, R.G. F.19.0015.F, F.J.F., 2020/10, pp. 365-366; Note that Belgium has recently signed a new tax treaty with France on November 9, 2021. In this respect, see P.-J. Wouters, "The Belgium-France Income and Capital Tax Treaty (2021): What's New?" *Bulletin for International Taxation*, 2022, Vol. 76, No 3, pp. 159-167.

<sup>61</sup> Article 261, 1° I.T.C. and Article 269, ¶1, 1° I.T.C.



provision.<sup>62</sup> In both instances, the shareholder must hold (i) a participation of at least 10% of the Belgian-resident company or an acquisition price or value of at least €2.5 million and (ii) the participation has been held for an uninterrupted period of at least one year, which may occur partly before and partly after the dividend distribution. Once a qualifying parent company holds a qualifying participation, all additional acquired shares also qualify, even if the one-year holding period is not met with respect to the additional shares.

### Less-Than-10% Investments

Following the ruling from the E.C.J. in the *Denkavit* case,<sup>63</sup> Belgium abandoned the condition that the parent must have held a participation of at least 10% for an uninterrupted period of at least one year preceding the distribution of the dividend. Therefore, the parent may hold the 10% participation for one entire year, which may occur partly before and partly after the dividend distribution. If the one-year hurdle is not fully met at the time the dividend is paid, the Belgian distributing company is allowed to pay out the net dividend only (*i.e.*, the gross dividend minus an amount equal to the dividend W.H.T. that would apply if the one-year holding period is not respected, thereby taking into account any treaty-based reductions that would be available if the one-year holding period is not met), without an actual payment to the Belgian tax authorities for the notional tax retained. If the shares are sold prior to meeting the holding period requirement, the amount of W.H.T. becomes due, increased by interest for late payment of tax. Otherwise, the undistributed portion of the dividend can be distributed freely once the one-year holding requirement is met.

The exemption from dividend W.H.T. is subject to the conditions mentioned in the P.S.D. with respect to the legal form, E.U. tax residence, and the parent company's compliance with a subject-to-tax requirement.<sup>64</sup> As a result of the amendment of the P.S.D., several types of entities that were not eligible for the W.H.T. exemption now qualify, most notably the "European company" or "*societas Europaea*" ("S.E."). The legal form requirement does not apply if dividends are paid to Belgian entities subject to Belgian C.I.T.

Corporate investors established in other E.E.A. Member States would be subject to double taxation if they held a participation in a Belgian company that was less than 10% but had an acquisition price or value of at least €2.5 million. Under these circumstances, a Belgium-resident corporate shareholder would be entitled to the D.R.D., which amounts to 100% as of January 1, 2018, and be allowed a full credit and refund for Belgian dividend tax withheld at source. In comparison, prior to January 1, 2018, the €2.5 million threshold did not apply for the exemption from

<sup>62</sup> Article 106, ¶¶5-6*bis* R.D./I.T.C.; Belgian tax authorities take the view that the agreement between Belgium and Taiwan does not qualify as a tax treaty. Therefore, the full dividend W.H.T. exemption for dividends distributed by a Belgian company will not be available to the extent such dividends are distributed to a Taiwanese parent company.

<sup>63</sup> .C.J., *Denkavit Internationaal B.V. and Denkavit France S.A.R.L. v. France*, December 14, 2006, Case C-170/05, available at [www.curia.europa.eu](http://www.curia.europa.eu). Note that this is the second case involving the Denkavit company; the first one (C-283/94, October 17, 1996) also concerned the treatment of dividends, the application of the P.S.D. and the calculation of the two-year minimum holding period required to benefit from the participation exemption.

<sup>64</sup> See Article 106, ¶¶5 R.D./I.T.C.

dividend W.H.T., meaning that a non-Belgian E.E.A. shareholder with an interest below 10% but an acquisition price or value of at least €2.5 million was subject to Belgian W.H.T. on any dividends received from its Belgian participation.<sup>65</sup> If the shareholder was not entitled to claim a foreign tax credit in its country of residence, the Belgian dividend was subject to double international taxation.

To remedy this unequal treatment, the Law of December 25, 2017, introduced a new dividend W.H.T. exemption. New Article 264/1 I.T.C. alleviates the participation requirement effective as of January 1, 2018. If the participation does not satisfy the 10% test, dividends can still be exempt from W.H.T. if the E.E.A.-based corporate shareholder owns a participation in the Belgian distributing company with a tax book value of at least €2.5 million for an uninterrupted period of at least one year (prior to and/or immediately after the distribution of the dividend). To curb any potential abuses, the new exemption does not apply if, *inter alia*, the beneficiary of the dividend is entitled to credit Belgian dividend W.H.T. against its mainstream tax liability and receive a full refund of any excess W.H.T. in the E.E.A. Member State where it is based. In addition, the beneficiary must certify that it meets the other P.S.D. criteria, e.g., that it has a legal form listed in the Annex to the P.S.D. and that it is subject to the normal C.I.T. regime in the other Member State.

This provision also introduces an exemption for Belgian companies distributing a dividend to a non-E.E.A. based shareholder who (i) is based in a country with which Belgium has concluded a tax treaty containing an exchange of information provision and (ii) owns a participation below 10% in the Belgian company but with an investment price or value of at least €2.5 million.

#### Liquidation/Redemption Distributions to Persons Not Entitled to the Participation Exemption

The W.H.T. rate is set at 30% if dividends result from a redemption of shares or a share buy-back.

Distributions pursuant to liquidations and redemptions are subject to 30% Belgian dividend W.H.T., but may be eligible for rate reductions or exemptions from W.H.T. under a tax treaty concluded by Belgium, the P.S.D., or the unilateral extension of the P.S.D. W.H.T. exemption discussed above.

Through December 2017, any repayment of share capital or share premium to the shareholders was exempt from dividend W.H.T., provided that the repaid capital consisted of paid-up fiscal capital, did not consist of reserves, and the reduction of capital was executed in accordance with the old Belgian Company Law Code (now replaced by the B.C.A.C.).

In order to combat certain abusive “step-up” structures, the Law of December 25, 2017, introduced a relatively complex set of rules governing the reduction and

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<sup>65</sup> Since January 1, 2018, Article 264/1, ¶1, second limb I.T.C. allows non-Belgian E.E.A. shareholders with an interest below 10% but with an acquisition price or value of at least €2.5 million to benefit from a full dividend W.H.T. exemption.

reimbursement to shareholders of fiscal share capital.<sup>66</sup> From January 1, 2018, any reduction of share capital, including qualifying share premium, will be deemed to be paid proportionally from (i) fiscal share capital and share premium and (ii) profits carried forward or retained earnings. Only insofar as the capital reimbursement is deemed to be paid from fiscal share capital and share premium will no dividend W.H.T. apply. The portion of such reimbursement that is deemed to stem from profits carried forward and retained earnings will be treated as a regular dividend subject to the rules for regular dividend distributions, as discussed above.

### **Abuse of European Union's Directives**

In February 2019, the E.C.J. ruled in the so-called *Danish cases* (Joined Cases C-116/16 and C-117/16) that the explicit transposition of the anti-abuse provisions of the E.U. Directives into national legislation or income tax treaties is not necessary to deny the benefits of these Directives in abusive situations.<sup>67</sup>

For the E.C.J., there is, *inter alia*, an indication of abuse when

- the recipient lacks substance, has no other economic activity in the country or has been interposed in a structure that otherwise would not be covered by the E.U. Directives; or
- the funds are passed on shortly after they are received, which indicates that the entity might be a mere flow-through or conduit to the ultimate recipient.

In December 2020, the Belgian Court of Appeals of Ghent endorsed the E.C.J.'s Danish cases doctrine and earmarked as abusive a W.H.T. exemption applied by a Belgian company distributing dividends to a Luxembourg S.P.V., because of the lack of substance in Luxembourg in combination with the artificial character of a number of steps in the transaction that was at stake.

## **TAX TREATMENT OF BORROWING AND INTEREST PAYMENT**

In principle, interest expense incurred by a company is tax deductible. However, limitations apply to the deduction.

### **General Expense Deduction Rule**

Like other costs and expenses, interest expenses are deductible by a company to the extent they<sup>68</sup>

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<sup>66</sup> Fiscal share capital is any portion of a company's equity that stems from actual contributions in cash or in kind made to the company by its current or past shareholders. It excludes any earnings and profits of the company that were converted to share capital for legal and accounting purposes but did not stem from contributions made by shareholders.

<sup>67</sup> For further details, see S. Baerentzen, "Danish Cases on the Use of Holding Companies for Cross-Border Dividends and Interest – A New Test to Disentangle Abuse from Real Economic Activity?" *World Tax Journal*, 2020, Vol. 12, No 1, pp. 3-52.

<sup>68</sup> Article 49 I.T.C.

- relate to the company's business activities,
- are incurred or borne during the taxable period,
- were incurred with a view to producing or maintaining taxable income, or
- are subject to proper documentation being provided.

### **General Interest Limitation Rule (Arm's Length Principle)**

Companies can deduct interest expenses to the extent they correspond to a market interest rate, taking into account the specific characteristics of the financing.<sup>69</sup> These include the currency exchange risk, the debtor's credit rating or creditworthiness, the duration of the loan, the timing of interest payments, the reimbursement of principal, and any collateral held as security by the lender.

If the interest charged between two related parties exceeds the interest charged in a comparable transaction between two unrelated parties, any excessive interest payment is not tax deductible by the borrower. If excessive interest paid or accrued by the borrower is not reported in the company's annual C.I.T. return, but rather added to its tax base as a result of a tax examination by Belgian tax authorities, the excessive interest deduction will be earmarked as an "abnormal or gratuitous advantage" and taxed currently without being eligible for a set-off by reason of a loss that is available for carryover from an earlier year or other deductions.<sup>70</sup>

### **Interest Payments to Tax Exempt/Low Taxed Non-E.U. Residents**

If a Belgian company pays interest to a nonresident who is either not subject to tax or who benefits from a tax regime notably more advantageous than the Belgian tax regime, such interest would not be tax deductible unless and to the extent the Belgian company can demonstrate that the interest payment (i) does not exceed the normal limits, *i.e.*, the interest rate is at arm's length and (ii) relates to real and sincere operations, *i.e.*, the loan is neither fictitious nor simulated and is entered into for genuine business, commercial or financial purposes.<sup>71</sup>

It is not required that the borrower has a need to borrow; the borrower is free to choose how it finances its business with shareholder equity, related party debt, or third-party debt. However, the borrower has the burden of demonstrating that the two conditions set forth above are met.

In principle, this rule is applicable to interest paid by Belgian companies to any non-resident who is exempt from tax or subject to a beneficial tax regime on the interest earned. However, in the *S.I.A.T.* case (C-318/10), the E.C.J. ruled that this rule infringes the European freedom to provide services, to the extent the application of the rule treats (i) interest paid to Belgian residents more favorably – not subject to the reversal of burden of proof-rule – than (ii) interest paid to other E.U. residents – subject to the reversal of burden of proof-rule.<sup>72</sup> As a result, it is generally understood that the two-prong rule described above, including the burden of proof element, applies only to interest paid or owed to non-E.U. residents.

<sup>69</sup> Article 55 and 56 I.T.C.

<sup>70</sup> Article 207, seventh limb, I.T.C.

<sup>71</sup> Article 54 I.T.C.

<sup>72</sup> E.C.J., *S.I.A.T. v. Belgium*, July 5, 2012, Case C-318/10, available [here](#).

Another rule provides that interest paid by Belgian companies to a beneficiary established in a jurisdiction listed as a tax haven for Belgian tax purposes would be tax deductible only to the following extent:<sup>73</sup>

- The Belgian company establishes that the interest relates to “genuine and sincere operations” (as defined herein above) with persons other than “artificial constructs.”
- The Belgian company reports the payment in an annex to its C.I.T. return.

This rule does not apply in either of two instances. The first is that the payment does not exceed €100,000 for a taxable period. The second is that the interest is paid to a non-E.U. person resident in a state with which Belgium has signed an income tax treaty containing a nondiscrimination clause or an automatic exchange of information clause.

### **E.B.I.T.D.A Limitation Rule**

#### **In General**

Belgium implemented Article 4 of the E.U. Anti-Tax Avoidance Directive (“A.T.A.D.”) into its national law. Therefore, companies are allowed to deduct excess borrowing cost only to the extent it does not exceed a cap.<sup>74</sup> Excess borrowing cost refers to an entity’s net funding cost, consisting of the difference between interest paid or accrued under its accounting method over interest received or accrued and recognized under its accounting method.<sup>75</sup> The cap is €3 million or 30% of the E.B.I.T.D.A. computed for income tax purposes, whichever is greater. The cap is referred to frequently as “fiscal E.B.I.T.D.A.”

#### **Fiscal E.B.I.T.D.A.**

The computation of fiscal E.B.I.T.D.A. begins with taxable profit. After that, several tax-technical corrections are made, which can be divided into two groups. The first group of corrections adds back to the taxable profit amortization deductions, depreciation deductions, and the amount of excess interest expense over interest income.<sup>76</sup> The second group of corrections removes income to which the dividends received deduction applies and income to which the innovation income deduction applies.<sup>77</sup> This reflects the view that exempt income is removed when computing fiscal E.B.I.T.D.A.

<sup>73</sup> Article 198, ¶1, 10° I.T.C.

<sup>74</sup> Article 198/1 I.T.C.

<sup>75</sup> See Article 73<sup>4/12</sup> R.D./I.T.C. that provides a description of income and expenses that are “economically equivalent to interest,” e.g., payments under profit participation loans, capitalized interest, foreign exchange gains/losses related to interest payments, guarantee provisions, discount on interest-free or abnormally low-interest loans.

<sup>76</sup> Article 198/1, ¶3, second limb I.T.C.

<sup>77</sup> Article 198/1, ¶3, third limb I.T.C.

*“This reflects the view that exempt income is removed when computing fiscal E.B.I.T.D.A.”*

### Exclusions

The fiscal E.B.I.T.D.A. limitation rule for interest expense deductions does not apply to any of the following:

- Income from financial operations of banks, insurance companies, pension funds, leasing companies, and factoring companies
- Income of standalone entities, essentially taxpayers without a foreign P.E. and without affiliates having a direct or indirect shareholding link of at least 25%
- Public-private partnership projects, essentially long-term public infrastructure projects

The following three types of loans are also out of scope:

- Loans concluded before June 17, 2016, unless fundamental changes have been made to the terms and conditions after that date. These grandfathered loans remain subject to the old Belgian 5:1 thin capitalization rule, under which interest payments or attributions in excess of a 5:1 debt-equity ratio are not tax deductible.
- Loans in relation to public-private cooperation projects
- Loans between Belgian entities that are part of the same group, as discussed in more detail, below

### Carryforward

Taxpayers can carry forward the excess borrowing costs that cannot be deducted during a financial year to a subsequent financial year or transfer them to another Belgian group entity.<sup>78</sup>

### Group Application

Belgian entities that are part of a group must share the interest deduction cap among themselves.<sup>79</sup> The allocation may be computed on a per capita basis among all members or in proportion to the level of the respective excess borrowing costs of each member. In the latter instance, a complex four-step approach must be applied when calculating fiscal E.B.I.T.D.A. of the group and its members.

If the overall E.B.I.T.D.A. of a Belgian group is less than €10 million, group entities may collectively waive their right to determine their individual E.B.I.T.D.A. in a specific tax form (275 CRC) that is part of the C.I.T. return.<sup>80</sup> In such a case, the interest capacity depends only on the €3 million threshold.

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<sup>78</sup> Article 194sexies I.T.C.; For further details, see M. Possoz and B. Buytaert, “De nieuwe EBITDA-interestaftrekbepanking,” *Tijdschrift voor Fiscaal Recht*, 2019/8, No 560, pp. 378-399.

<sup>79</sup> Article 198/1, ¶3, fourth limb, first dash I.T.C.

<sup>80</sup> Article 73<sup>4/11</sup>, ¶3 and 73<sup>4/12</sup>, ¶2 I.T.C.

## **Interest on Debt Pushdowns Payable at Redemption**

Interest must be related to the conduct of a business in order to be deductible.<sup>81</sup> That is not clearly the case when the underlying debt is incurred to

- acquire a qualifying participation in another company,<sup>82</sup> or
- pay back equity or distribute dividends to the company's shareholders, as illustrated in the following case.

On May 8, 2018, the Court of Appeals in Antwerp handed down a remarkable ruling regarding the deduction of interest expense that at the time of a redemption is treated as a capital gain.<sup>83</sup> The facts of the case are as follows:

- On July 1, 2012, a Belgian company ("BelCo") borrowed €450 million from its Belgian parent company ("Parent"), incurring interest expense computed at an arm's length rate.
- €350 million of the amount borrowed was used by BelCo to reimburse share capital to its shareholders, including Parent, and €100 million was used to pay an interim dividend to its shareholders, also including Parent.
- The capital reduction and the interim dividend payment had been authorized by the shareholders prior to the loan agreement between BelCo and Parent.
- For tax assessment year 2013, BelCo claimed a deduction of €9,689,900 of interest expense owed to Parent.

The Belgian tax authorities challenged the deduction claiming it did not meet one of the essential requirements of Article 49 I.T.C. (see prior discussion of the general expense deduction rule), as it was not a cost or expense incurred to produce or maintain taxable income. The Court of Appeals in Antwerp sided with the Belgian tax authorities, taking the view that the reduction and payback of share capital and distribution of dividends to shareholders is not automatically a cost or expense that was incurred to produce or maintain taxable income for BelCo. After having examined the facts at hand, the Court of Appeals ruled that the interest expense was not deductible. BelCo filed an appeal against this ruling with the Court of Cassation, the highest Belgian court in tax matters.

As of May 30, 2022, the Court of Cassation has not yet ruled on the matter. The ultimate outcome will be of particular interest because the fact pattern illustrates a typical Belgian technique used to realize a "debt push-down," *i.e.*, a replacement of equity in BelCo by debt owed to Parent. From a cash-flow perspective, neither Parent nor BelCo lost much cash, but BelCo owed interest on the full loan amount of €450 million. Although the Court of Appeals decision remained silent on the matter, it is likely that the interest paid to Parent was not effectively taxable because Parent either had carried-forward tax losses or incurred tax-deductible interest expenses of its own.

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<sup>81</sup> Article 49 I.T.C.

<sup>82</sup> Even though a participation in another company may result in a tax-exempt dividend income or capital gains only, it is generally accepted that interest incurred in connection with the financing or the acquisition of the participation is tax deductible.

<sup>83</sup> Court of Appeals in Antwerp, May 8, 2018, R.G. 2016/AR/2108, available [here](#).



## **Special Fact Patterns related to Interest Expenses**

### **Notional Interest Deduction**

Effective January 1, 2006, Belgian companies were entitled to a notional interest deduction (“N.I.D.”). The N.I.D. is a tax deduction for hypothetical interest owed on the company’s equity as it appears in its commercial balance sheet. The notional interest rate is restated every year. For assessment year 2022 (financial book years ending on or after December 31, 2021), the N.I.D. rate is equal to 0% (0.34% for S.M.E.’s).

**“As an austerity measure, unused portions of the N.I.D. can no longer be carried over to subsequent tax years.”**

As an austerity measure, unused portions of the N.I.D. can no longer be carried over to subsequent tax years.<sup>84</sup> To curb perceived abuses, the amount of equity that serves as the basis for computation of the N.I.D. is adjusted by deducting, among other things, the commercial book value of participations that qualify for the participation exemption.<sup>85</sup>

Following the Belgian C.I.T. Reform Law of December 25, 2017, the N.I.D. regime was substantially amended.<sup>86</sup> Effective as of tax assessment year 2019, the N.I.D. is applicable only to the increase in qualifying equity rather than the full amount of the qualifying equity of the previous tax year. Additionally, only one-fifth of any such increase will be taken into account for the year in which the qualifying equity is booked, and the balance will be taken into account in equal installments over each of the four subsequent years. Given the low N.I.D. rate – which is adjusted annually based on the interest rate on Belgium’s ten-year government bonds during the preceding year – the practical use of the N.I.D. has become negligible.

### **Patent Income Deduction and Innovation Income Deduction**

Belgium’s patent income deduction (“P.I.D.”) was abolished as of July 1, 2016, subject to grandfathering according to which the P.I.D. could still be applied until June 30, 2021, for qualifying patents received or applications filed before July 1, 2016.

A new innovation income deduction, or I.I.D., was introduced, based on the modified nexus approach recommended by the O.E.C.D. in B.E.P.S. Action 5. The new regime is effective as of July 1, 2016.

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<sup>84</sup> Law of December 13, 2012, on Tax and Financial Provisions (*Belgian State Gazette*, December 20, 2012). Transitional provisions are available regarding the right to utilize any existing “inventory” of carried over N.I.D. going forward.

<sup>85</sup> The initial rule that excluded the net assets of a Belgian company held through a branch 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.

<sup>86</sup> Article 49 of the Law of December 25, 2017, on C.I.T. Reform (*Belgian State Gazette*, December 29, 2017).

Under the I.I.D. regime, a corporate taxpayer can deduct from the taxable base up to 85% of its net innovation income, resulting in an effective C.I.T. that can be as low as 3.75% (*i.e.*, 25% regular Belgian C.I.T. rate multiplied by the remaining 15% of net innovation income).<sup>87</sup>

One of the benefits of the I.I.D. over its predecessor, the P.I.D. regime, is that income from copyrighted software is also eligible for the 85% deduction.<sup>88</sup> Through June 30, 2022, the former P.I.D. regime and the new I.I.D. regime could be applied simultaneously.

### **Withholding Tax on Outbound Interest Payments**

In principle, interest paid by any Belgian company is subject to a W.H.T. of 30%.<sup>89</sup> Often, this domestic rate can be reduced by bilateral tax treaties, the E.U. Interest and Royalty Directive, and several domestic exemptions that have been implemented in Belgium. This will be the case if the Belgian company borrowed from an E.U.-affiliated company, a Belgian bank, a credit institution located in the E.E.A., or a lender resident in a tax treaty country. It applies also if the Belgian company issued registered bonds to nonresident taxpayers. In some cases, certificates must be filed alongside the W.H.T. return.

## **CAPITAL DUTY**

Pursuant to the Law of June 23, 2005, the rate of capital tax is set at 0%<sup>90</sup> for all contributions to share capital occurring on or after January 1, 2006.

The contribution in kind of Belgian situs real estate may be subject to the real estate transfer tax (10% in Flanders; 12.5% in Brussels and Wallonia) to the extent the contribution is not made exclusively or entirely in return for shares of stock. A classic example is the contribution of real estate together with an existing mortgage loan that predates the contribution.

## **V.A.T.**

On the basis of E.C.J. case law, a distinction is made between active and passive holding companies for purposes of V.A.T.<sup>91</sup> A passive holding company has no economic activity that gives entitlement to claim a credit for input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or participations. In comparison, an active holding

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<sup>87</sup> If, in the tax year for which the I.I.D. is claimed, insufficient taxable income is left to absorb the full amount of the I.I.D., any unused portion can be carried forward to subsequent tax years, with no time limit (Article 205/1, ¶1, second limb I.T.C.).

<sup>88</sup> For further details, see W. Heyvaert, “Belgium’s New Innovation Income Deduction Regime,” *European Taxation*, 2018, Vol. 58, Issue 5, pp. 206-209.

<sup>89</sup> Article 261, 1° I.T.C. and Article 269, ¶1, 1° I.T.C.

<sup>90</sup> Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

<sup>91</sup> See *e.g.* E.C.J., *E.D.M. v Fazenda Pública*, April 29, 2004, Case C-29/08, available [here](#).

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

Based on a response in 2010 of the Belgian Minister of Finance to a Parliamentary Question,<sup>92</sup> even V.A.T. incurred in connection with a sale of shares may be creditable and refundable, under appropriate circumstances. This insight is derived from the E.C.J.'s ruling *Skatteverket v. A.B. S.K.F.*<sup>93</sup> First, one should determine whether there is in principle a direct relationship between a previous transaction, such as an input transaction on which input V.A.T. is chargeable, and a subsequent transaction, such as an output transaction that is subject to output V.A.T. If a relationship exists, the input V.A.T. can be credited by the holding company in computing its V.A.T. payments to the Belgian government. However, if there is a direct relationship between an input transaction and an output transaction that is either exempt from V.A.T. or outside the scope of V.A.T., the input V.A.T. is not creditable, as was the situation in E.C.J.'s ruling in *B.L.P. Group*.<sup>94</sup> Nonetheless, the input V.A.T. may still be creditable when the cost for the input services is part of the general expenses of the taxpayer and is included in the price charged by the taxpayer for goods delivered or services rendered to its affiliate. In essence, the parent can create its own connection by acts it takes and records it keeps.

This principle, too, was formulated in the *Skatteverket v. A.B. S.K.F.* case and the Belgian tax administration accepted that input V.A.T. could be creditable in the event of an issuance of new shares or the purchase of shares. However, V.A.T. credit is not available if the cost of the input transaction on which V.A.T. was charged is included in the sale price of the shares, which is either exempt or out of the scope of V.A.T. On May 3, 2018, the Advocate General of the E.C.J. clarified that V.A.T. incurred in connection with a failed sale of shares is fully deductible in the above-mentioned circumstances.<sup>95</sup>

## 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. As such, a Private P.R.I.C.A.F. is not a holding company.

A Private P.R.I.C.A.F. can take the form of a company limited by shares ("N.V.") or a limited partnership with a share capital ("C.V.A."). It is a closed-end fund, established by private investors, *i.e.*, persons investing at least €25,000 each.<sup>96</sup> The Private P.R.I.C.A.F. must have at least six private investors."



<sup>92</sup> Parl. Question, No. 299 of January 12, 2010, Brotcorne, Q&A, Chamber 2009-2010, No. 52-102, 107.

<sup>93</sup> E.C.J., *Skatteverket v. A.B. S.K.F.*, October 29, 2009, Case C-29/08, available [here](#).

<sup>94</sup> E.C.J., *B.L.P. Group P.L.C. v. Commissioners of Customs & Excise*, April 6, 1995, Case C-4/94, available [here](#).

<sup>95</sup> Opinion of Advocate General Kokott in E.C.J., *Ryanair L.T.D. v. The Revenue Commissioners*, October 17, 2018, Case C-249/17, available [here](#).

<sup>96</sup> Note that the Royal Decree of May 8, 2018, decreased the minimum investment threshold from €100,000 to €25,000.

A Private P.R.I.C.A.F. exists for a period of 12 years. This period can be extended by the investors twice, each time for a period of three years. The extensions must be approved by 90% of the votes cast, representing at least 50% of the share capital.

Private P.R.I.C.A.F.'s may invest in a broad range of financial instruments issued by *unlisted* companies. This includes (i) shares, bonds, and debt instruments of all kinds; (ii) securities issued by other undertakings for collective investment; and (iii) derivative financial instruments such as subscription rights and options. Other investments are either partially or temporarily authorized or prohibited.

The Law of March 26, 2018, abolished a restriction that prohibited a Private P.R.I.C.A.F. from acquiring a controlling stake in a portfolio company.

Private P.R.I.C.A.F.'s must register with the Belgian tax authorities. Furthermore, the Royal Decree of May 8, 2018, provides Private P.R.I.C.A.F.'s with the ability to create compartments or silos.

A Private P.R.I.C.A.F. is subject to C.I.T., but its tax base deviates from the normal C.I.T. regime and is limited to certain elements such as non-arm's length benefits received, nondeductible expenses, and payments in lieu of dividends in stock-lending transactions. Private P.R.I.C.A.F.'s do not pay other income taxes.

The Law of March 26, 2018, granted private investors in a Private P.R.I.C.A.F. a tax reduction of 25% of capital losses realized on the shares of a Private P.R.I.C.A.F. established after January 1, 2018. The loss will be equal to the excess of (i) the capital invested by the private investors over (ii) the sum of the distributions made by the Private P.R.I.C.A.F. to the private investors as a result of the company's complete liquidation, plus the dividends paid to the private investors. The tax reduction is capped at €25,000 without indexation.

Dividends distributed by a Private P.R.I.C.A.F. are in principle subject to a 30% W.H.T. Several exceptions exist:

- Distributions paid from capital gains realized on shares held by a Private P.R.I.C.A.F. are exempt from W.H.T. As of January 1, 2018, the general participation exemption for capital gains on shares applies only if a corporate taxpayer holds a stake of at least 10% in the capital of the underlying company or the underlying investment has an acquisition value of at least €2.5 million. This requirement, as well as the one-year holding requirement, do not apply to participations held by an investment company, such as a Private P.R.I.C.A.F.
- Share redemptions and liquidation gains are also exempt from W.H.T.
- The Law of March 26, 2018, extended the application of a reduced dividend W.H.T. rate of 15% or 20% (the *V.V.P.R.bis* regime) to indirect investments, such as those held through a Private P.R.I.C.A.F.

## STATE AID INVESTIGATION<sup>97</sup> - BELGIAN EXCESS PROFIT RULINGS

In principle, taxation of Belgian companies is based on the total amount of book profits recorded on the company's books, including certain "disallowed expenses" as well as any distributed profits in the form of dividends.

However, the Belgian "Excess Profit Rulings" ("E.P.R.") regime allowed for special treatment of selected companies that are part of a multinational group.<sup>98</sup> This was based on the premise that the Belgian subsidiary or branch of the multinational group makes a profit that could not be made by a hypothetical stand-alone company. This excess profit results from being part of a multinational group that brings along benefits such as synergies, economies of scale, reputation, and client and supplier networks. This excess profit was deductible from the Belgian entity's tax base, subject to the issuance of a favorable advance tax ruling by the Belgian Ruling Committee.

Between 2005 and 2014, Belgium applied the E.P.R. regime to approximately 55 entities. Most of them were allowed to claim a 50% to 90% deduction, without any indication that the deducted amounts were being included in a tax base elsewhere.

Surprisingly, Belgium neither notified the Commission of these rulings nor waited for the Commission's green light under the so-called "standstill obligation" before putting into effect the E.P.R. regime.

Nonetheless, due to the intensive publicity campaign under the catch phrase "Only in Belgium," the regime eventually drew the Commission's attention, triggering a preliminary investigation in December 2013 and a formal in-depth investigation in February 2015.

In January 2016, the Commission reached an adverse decision, concluding that the E.P.R. regime constituted an aid scheme within the meaning of Article 1(d) of Council Regulation (E.U.) 2015/1589. The Commission was of the view that by discounting excess profit from a beneficiary's tax base, Belgian tax authorities selectively misapplied the I.T.C. and endorsed unilateral downward adjustments of the beneficiaries' tax base although the legal conditions were not fulfilled.

The Commission also argued that the Belgian practice of issuing E.P.R.'s in favor of certain companies may have discriminated against certain other Belgian companies, which did not or could not receive a ruling. The Commission found that Belgian E.P.R.'s gave a selective advantage to specific multinational companies, allowing them to pay substantially less than the regular amount of Belgian C.I.T. they would owe without an E.P.R. being in place.

The Commission issued a recovery order under which Belgium was required to take all necessary measures to recover the purported aid from all beneficiaries during the relevant ten-year period. The total amount to be recovered exceeded €900 million.

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<sup>97</sup> For further details about State Aid, see Chapter V, A.

<sup>98</sup> Former Article 185, ¶2, b) I.T.C.

*“In contrast with what is written in most of Belgium’s trade press, the Belgian E.P.R. saga is far from over.”*

Following the Commission’s negative decision and recovery order, Belgium and Magnetrol International, one of the beneficiaries of purported aid, lodged an action before the General Court of the European Union (“E.G.C.”).

In February 2019, the E.G.C. annulled the Commission’s decision. The court found that the Commission failed to establish the existence of an aid scheme, but did not conclude on whether the E.P.R.’s gave rise to unlawful State Aid.

In April 2019, the Commission lodged an appeal to the E.C.J. to seek clarity on the standards for establishing a State Aid scheme.

In September 2019, the Commission also announced the opening of separate in-depth investigation procedures in which E.P.R.’s are labeled as individual aid.

In December 2020, Advocate General (“A.G.”) Kokott issued a favorable opinion regarding the appeal lodged by the Commission against the E.G.C.’s judgment of 14 February 2019. According to the A.G., the Commission rightfully earmarked the Belgian practice of making downward adjustments to profits of Belgian corporate taxpayers forming part of a multinational group as an unlawful State Aid scheme. The opinion recommended that the E.C.J. sets aside the judgment of the E.G.C. and refer the case back to the E.G.C. for a second review.<sup>99</sup>

In September 2021, the E.C.J. followed the A.G.’s opinion and overruled the E.G.C.’s Ruling. The E.C.J. ruled that the three conditions for an aid scheme to exist were met. However, the E.C.J. only looked into the methodological aspects of the E.G.C.’s judgement and referred the case back to the E.G.C., which will have to decide on open questions such as the existence of a selective advantage and the identification of the beneficiaries of the alleged aid.

In contrast with what is written in most of Belgium’s trade press, the Belgian E.P.R. saga is far from over. The E.G.C.’s first decision might turn out to be a curse in disguise for Belgium because it established that Belgian tax authorities enjoy a genuine margin of discretion when granting the tax rulings. This conclusion, which led to the reversal of the Commission’s aid scheme theory, might now back the Commission’s claim that all or some of the rulings were selective and, thus, amount to unlawful State Aid.<sup>100</sup>

## B.E.P.S. AND F.A.T.C.A.

### In General

In reaction to the O.E.C.D. initiative to combat base erosion and profit shifting (the “B.E.P.S. Project”), Belgium has implemented the following actions:

- Action Item 5 regarding the adoption of the I.I.D. using the modified nexus approach in lieu of the P.I.D.

<sup>99</sup> For further details, see W. Heyvaert and V. Sheikh Mohammad, “Turning Point in the Belgian Excess Profit Rulings Appeal Procedure - Advocate General Kokott Backs the European Commission’s Aid-Scheme Theory,” *AKD News-flash*, December 18, 2020.

<sup>100</sup> For further details, see W. Heyvaert and V. Sheikh Mohammad, “Belgium Following the Recent Excess Profit Rulings Decision,” *European Taxation*, 2020, Vol. 60, Issue 5, pp. 190-198.

- Action Item 2 regarding hybrid mismatches
- Action Item 3 regarding C.F.C. rules
- Action Item 4 regarding the interest limitation rule
- Action Items 8 through 10 and 13 regarding transfer pricing
- Most measures were implemented in Belgium by December 31, 2018.

The Minister of Finance has 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 Commission before taking legislative action regarding certain Action Items.

As of May 30, 2022, the Belgian Minister of Finance is holding a public consultation on the transposition of O.E.C.D.'s Pillar Two, regarding a 15% minimum tax, which was being converted into an E.U. Directive. On June 18, 2022, Hungary refused to vote in favor of Pillar Two and the matter continues to face uncertainty.

### **B.E.P.S. Action 2: Hybrid Mismatches**

The Belgian government has implemented the E.U. anti-hybrid mismatch rule provided for in the A.T.A.D.<sup>101</sup> Dividends derived from a subsidiary are excluded from the D.R.D. to the extent that the subsidiary has deducted, or can deduct, this income from its profit.

#### **Definitions**

Definitions of hybrid mismatch, hybrid entity, and hybrid transfer were introduced into Belgian tax law:<sup>102</sup>

- A hybrid mismatch is an arrangement resulting in either of two tax benefits. The first is a deduction of expenses for both a Belgian company or permanent establishment and a foreign enterprise or establishment thereof resulting in a double deduction. The second is a deduction for one of the participants to the arrangement without an income inclusion by the other participant resulting in a deduction without inclusion in income.
- A hybrid mismatch requires associated enterprises that are part of the same group or that act under a structured arrangement. No hybrid mismatch exists where the non-inclusion is due to the application of a tax regime that derogates from the standard tax law or differences in the value attributed to a payment, including differences resulting from the application of transfer pricing rules.
- A hybrid entity is any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction but is treated as a transparent entity under the tax laws of another jurisdiction.

<sup>101</sup> Articles 185, 198, and 203 I.T.C.

<sup>102</sup> See Article 2, ¶1 I.T.C.

A “hybrid transfer” is any arrangement to transfer a financial instrument that is treated for tax purposes as having been derived simultaneously by more than one of the parties to the arrangement.

### *Taxable Hybrids*

#### Disregarded Permanent Establishment Mismatch Rule

Belgian companies will be taxed on profits attributable to a permanent establishment in another E.U. Member State that was exempt in that Member State under a tax treaty. Note that the profits must be realized due to a hybrid mismatch arrangement and not taxed in the jurisdiction where the permanent establishment is located.

#### Reverse Hybrid Entity Mismatch Rule

Belgium will consider a hybrid entity incorporated or established in Belgium to be taxable if one or more associated nonresident entities are established in one or more jurisdictions that consider the Belgian entity to be taxable.

The hybrid entity's income will be taxed in Belgium to the extent that it is not already taxed under the laws of Belgium or any other jurisdiction. This rule does not apply to collective investment vehicles.

#### Financial Instrument Mismatch

A taxable hybrid mismatch may occur due to different characterizations of the same financial instrument or item of income resulting in a deduction for the foreign enterprise or its establishment and no inclusion for the Belgian company or establishment of the deemed beneficiary under the laws of the other jurisdiction.

#### Hybrid Entity Mismatch

A hybrid mismatch exists where deductible income is paid by a foreign hybrid entity or its establishment in another country without a taxable inclusion for the Belgian company. This is the case when a foreign hybrid entity is considered transparent for Belgian purposes and as a taxable entity in the foreign jurisdiction.

### *Nondeductible Hybrids*

The deduction of expenses in Belgium in the context of hybrid mismatches will be disallowed.

#### Double Deduction Rule

Payments will be disallowed if there is a double deduction, for both a Belgian company or permanent establishment and a foreign enterprise or permanent establishment, from non-dual inclusion income.

#### Deduction Without Inclusion Rules

The deduction of hybrid mismatch payments is prohibited in six instances where a payment is deductible in Belgium without a corresponding foreign inclusion:

- **Financial instrument mismatches.** A payment is made under a financial instrument where (i) the deduction without inclusion would be due to a difference in characterization of the instrument or income and (ii) the payment



is not included in the taxable income of the beneficiary within a reasonable period of time.

- **Reverse hybrid entity mismatches.** A payment is made to a reverse hybrid entity, *i.e.*, an entity that is considered a taxpayer under Belgian law and as a transparent entity under the laws of another jurisdiction.
- **Hybrid allocation mismatches.** A payment is made to an entity with one or more establishments, where the non-inclusion abroad is the result of differences in the allocation of payments made to the hybrid entity's head office and its establishment, or between two or more establishments of that same entity.
- **Hybrid permanent establishment mismatches.** A payment is made to an entity that is regarded as a permanent establishment under the laws of its head office but disregarded under the law of the establishment's jurisdiction and the corresponding income is not taxable under the laws of the head office's jurisdiction.
- **Hybrid entity mismatches.** A payment is claimed as a deduction without being included in the beneficiary's taxable income, such as if a Belgian entity is treated as taxable in Belgium but as transparent in the recipient's jurisdiction.
- **Deemed permanent establishment payment mismatches.** A deemed payment is made between a head office and its permanent establishment, or between two or more permanent establishments, that has already been deducted from non-dual inclusion income.



#### Imported Hybrid Mismatches

Imported hybrid mismatches occur between interested parties in foreign jurisdictions who shift the tax consequences to Belgium. For example, a Belgian entity contracts an ordinary loan with a foreign entity that itself has concluded a hybrid loan with another foreign entity.

#### Tax Residency Mismatch Rule

Payments are not deductible if they are made by a Belgian domestic company that is also a tax resident in one or more other jurisdictions and they are deductible from income in one of the other jurisdictions against income that is not taxable in that other jurisdiction. A deduction is allowed, however, if the other jurisdiction is an E.U. Member State with which Belgium has concluded a tax treaty that determines the company is treated as a Belgian-resident taxpayer.

Most of the above rules are applicable from 2020 (book years ending December 31, 2019).

#### **B.E.P.S. Action 3: C.F.C. Rules**

Until January 1, 2019, Belgium did not have C.F.C. legislation in place *per se*, but it had, and still has, extensive anti-abuse rules with an effect similar to C.F.C. rules. For example, Article 344 §2 of the I.T.C. tackles transfers of assets to entities that are resident in tax havens. Article 54 of the I.T.C. denies the deduction of interest payments to low-taxed entities and Article 307 of the I.T.C. imposes a reporting obligation on taxpayers making payments to offshore entities.

Belgian law contains a look-through tax, sometimes referred to as “Cayman tax” for income derived by individual taxpayers from the use of foreign vehicles such as trusts or foundations. Since 2014, these juridical arrangements must be reported on the individual’s personal income tax return, and in many instances the trust or foundation will be considered tax transparent so that the income will be taxable directly in the hands of the resident individual who is the beneficiary.

In addition, the A.T.A.D. contains a C.F.C. component, which is intended to deter profit shifting to low-tax or no-tax jurisdictions. These C.F.C. rules are mandatory in all E.U. Member States. The Commission aims to discourage income shifting by re-attribution of income from a passive, lightly taxed C.F.C. to its E.U. parent company.

Belgium has opted to implement C.F.C. rules that target income only when derived by a C.F.C. through non-genuine arrangements set up for the essential purpose of obtaining a tax advantage.<sup>103</sup> These new rules became effective as of January 1, 2019.

A C.F.C. is defined as a low-taxed foreign company or permanent establishment in which a Belgian corporate taxpayer holds, directly or indirectly, more than 50% of the capital or voting rights, or is entitled to receive more than 50% of the profits of that entity. A C.F.C. is deemed to be low taxed if (i) it is not subject to any income tax or (ii) is subject to income tax at a rate that is less than 50% of the rate that would be imposed were it a resident of Belgium.<sup>104</sup>

The income included under the C.F.C. rules is based on transfer pricing rules. If a C.F.C. does not perform significant people functions (“S.P.F.”), does not own business assets, or does not assume risks, the arrangement is considered to be non-genuine. In comparison, income that is generated through assets or risks connected to the performance of S.P.F.’s by a Belgian taxpayer is included in the Belgian taxpayer’s tax base.

If a C.F.C. distributes income that has already been subject to tax at the level of the Belgian corporate shareholder, the amount distributed is matched by a full deduction, thereby avoiding double taxation of the same income in Belgium.

#### **B.E.P.S. Action 4: Excessive Interest Deductions**

Similar to most other countries, Belgium already had various rules limiting excessive interest deductions. The most well-known rule is the 5:1 thin capitalization rule, under which interest payments or attributions in excess of a 5:1 debt-equity ratio are not tax deductible. Belgium has implemented the A.T.A.D. by providing an interest limitation rule to discourage companies from creating artificial debt arrangements designed to minimize tax. This rule entered into effect on January 1, 2019, and is effective for tax assessment year 2020 and later. Interest is deductible only up to a certain amount, viz., the greater of 30% of an entity’s tax-adjusted earnings before interest, taxes, depreciation, and amortization (essentially E.B.I.T.D.A.) or €3 million. This was accomplished by enactment of the Law of December 25, 2017, which transposed A.T.A.D. into national law.<sup>105</sup>

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<sup>103</sup> Article 185/2, ¶1 I.T.C.

<sup>104</sup> *Id.*, ¶2.

<sup>105</sup> Article 40 of the Law of December 25, 2017, on the C.I.T.Reform (*Belgian State Gazette*, December 29, 2017) introducing Article 198/1 I.T.C., to take effect on January 1, 2020.

Loans entered into prior to June 17, 2016, are grandfathered. Consequently, interest on such loans will not be subject to the limitation based on 30% of E.B.I.T.D.A., provided that no substantial changes are made to these loans on or after June 17, 2016. According to the Minister of Finance, substantial changes are, *inter alia*, changes in the duration of the loan, the interest rate due under the loan, or a party to the loan. Additionally, financial institutions are carved out of the interest limitation rule altogether.<sup>106</sup>

For purposes of the interest limitation rule, certain items are earmarked as equivalent to interest and, thus, captured by the rule. A Royal Decree dated December 27, 2019, provides a description of income and expenses that are economically equivalent to interest. Included are payments under profit participating loans, capitalized interest, foreign exchange gains/losses related to interest payments, guarantee provisions, and original issue discount on interest-free or abnormally low-interest loans. Taxpayers seeking certainty can request a ruling as to specific costs and products.

### **B.E.P.S. Actions 8, 9, 10, and 13: Transfer Pricing**

Belgium has transfer pricing rules in place to avoid profit shifting, and in recent years transfer pricing audits have increased significantly. However, until recently, there were no specific statutory transfer pricing documentation requirements under Belgian law. It is of course advisable to have sufficient documentation available, as a lack of documentation may result in a thorough transfer pricing audit.

Belgium has enacted legislation to introduce specific transfer pricing documentation requirements based on B.E.P.S. Action 13. This means that the O.E.C.D.'s recommended three-tiered approach to transfer pricing documentation is mandatory in Belgium. As a result, a Belgian entity forming part of an international group must compile a Master File and a Local File, if certain criteria are met. In addition, if the ultimate parent of a multinational group is a Belgian company, and if it has gross consolidated revenue of at least €750 million, it must file a Country-by-Country Report with the Belgian tax authorities within 12 months from the closing of the consolidated financial statements of the group.

### **F.A.T.C.A.**

F.A.T.C.A.'s primary function is to require financial institutions outside the U.S. to report information on U.S. account holders to the I.R.S. The associated penalty for noncompliance is the "big stick" of a 30% U.S. W.H.T. on certain income and principal payments to recalcitrant financial institutions. The W.H.T. applies to payments made by all persons, even those unrelated to the U.S. account in issue.

On April 23, 2014, Belgium concluded a Model 1 Reciprocal Agreement with the U.S., meaning that foreign financial institutions established in Belgium will be required to report information on U.S. account holders directly to the Belgian tax authorities, who in turn will report to the I.R.S.

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<sup>106</sup> For further information on the interest limitation rule, see W. Heyvaert and E. Moonen "Belgium – ATAD Implementation in Belgium: An Analysis of the New Interest Limitation Rule," *European Taxation*, 2019, Vol. 59, No. 7 pp. 354-360.

## INCOME TAX TREATIES

As of January 1, 2022, Belgium has in effect 99 income tax treaties with the jurisdictions listed below.<sup>107</sup>

Albania	France	Malta	Slovakia
Algeria	Gabon	Mauritius	Slovenia
Argentina	Georgia	Mexico	South Africa
Armenia	Germany	Moldova	South Korea
Australia	Ghana	Mongolia	Spain
Austria	Greece	Montenegro	Sri Lanka
Azerbaijan	Hong Kong	Morocco	Sweden
Bahrain	Hungary	Netherlands	Switzerland
Bangladesh	Iceland	New Zealand	Taiwan
Belarus	India	Nigeria	Tajikistan
Bosnia & Herzegovina	Indonesia	Norway	Thailand
Brazil	Ireland	Oman	Tunisia
Bulgaria	Israel	Pakistan	Turkey
Canada	Italy	Philippines	Turkmenistan
Chile	Ivory Coast	Poland	Uganda
China	Japan	Portugal	Ukraine
Congo (Dem. Rep.)	Kazakhstan	Qatar	U.A.E.
Croatia	Kosovo	Romania	U.K.
Cyprus	Kuwait	Russia	U.S.A.
Czech Republic	Kyrgyzstan	Rwanda	Uruguay
Denmark	Latvia	San Marino	Uzbekistan
Ecuador	Lithuania	Senegal	Venezuela
Egypt	Luxembourg	Serbia	Vietnam
Estonia	Macedonia	Seychelles	
Finland	Malaysia	Singapore	

In addition, Belgium has in effect a substantial number of Tax Information and Exchange Agreements (“T.I.E.A.’s”). Nearly all of these T.I.E.A.’s are concluded with countries that do not have a comprehensive income tax treaty in force with Belgium, *i.e.*, most often tax havens.

Belgium signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“M.L.I.”), thereby incorporating the minimum standards outlined by the B.E.P.S. Project into its existing tax treaties. Belgium designated 99 of its Income Tax Treaties as Covered Tax Agreements, *i.e.* tax treaties to be modified through the M.L.I.<sup>108</sup>

On October 1, 2019, the M.L.I. entered into force for Belgium. For an income tax treaty to be covered by the M.L.I., both signatories must have (i) joined the M.L.I., (ii)

<sup>107</sup> Belgium has negotiated or is negotiating new treaties with several other countries.

<sup>108</sup> See the official website of the Belgian Ministry of Finance for the full list of countries.

included each other in their list of covered Income Tax Treaties, and (iii) deposited their instruments of ratification.

Belgium submitted reservations against the agency permanent establishment provision. Regarding the elimination of double taxation provided for in the M.L.I., Belgium will incorporate Option B regarding the credit method in its existing double tax treaties so long as the other contracting state is also a party to the M.L.I. and has not stated any reservations regarding this provision.

Recent significant changes include the signature of a new tax treaty with France on November 9, 2021.<sup>109</sup> Other changes include the signature of an additional protocol to the tax treaty with Norway on September 9, 2021 and the notification by Belgium and the Netherlands to the O.E.C.D. Secretariat on November 25, 2021, to bring their treaty under the umbrella of the M.L.I.

## D.A.C.6 – MANDATORY DISCLOSURE OF AGGRESSIVE CROSS BORDER TAX STRUCTURES<sup>110</sup>

*“For any failure to report or timely report, a fine is imposed ranging between €5,000 and €50,000.”*

On May 25, 2018, the Council of the European Union adopted Directive (E.U.) 2018/855 (referred to as “D.A.C. 6”). This Directive introduced mandatory disclosure rules for E.U.-linked intermediaries or, under specific circumstances, for taxpayers themselves (e.g., when the intermediary is precluded from reporting by virtue of the client-attorney privilege).

Belgium implemented the Directive into domestic law on December 12, 2019 (*Belgian State Gazette*, December 30, 2019). Under the Belgian Law, cross-border arrangements are reportable if they meet at least one of the hallmarks set out in the Law (which are identical to hallmarks A-E listed in Annex IV of the Directive). Hallmarks are broad categories setting out particular characteristics identified as potentially indicative of aggressive tax planning. Most hallmarks enter into play only if they meet a so-called “main benefit test” (i.e., where a tax benefit is the main or one of the main objectives of the arrangement). The Belgian Law does not cover purely domestic arrangements.

Until recently, the reporting deadlines were (a) August 31, 2020, for arrangements with a first step implemented between June 25, 2018 and July 1, 2020, and (b) within 30 days for arrangements with a first step implemented effective July 1, 2020 or later. However, due to the COVID-19 crisis, Belgium extended these deadlines.

For any failure to report or timely report, a fine is imposed ranging between €5,000 and €50,000. For filing an insufficient or incomplete report, a fine is imposed ranging between €1,250 and €12,500. The amounts double when the infringement is intentional. Likewise, higher penalties apply when an intermediary (or the relevant taxpayer) commits multiple infringements.

<sup>109</sup> In this respect, see P.-J. Wouters, “The Belgium-France Income and Capital Tax Treaty (2021): What’s New?” *Bulletin for International Taxation*, 2022, Vol. 76, No 3, pp. 159-167.

<sup>110</sup> See W. Heyvaert and V. Sheikh Mohammad, “European Union’s New Reporting Obligations for Tax Intermediaries: Key Features of the Belgian Administrative Guidance – D.A.C.6,” *Insights*, Vol. 8, No 2 (2021), pp. 3-10.

An intermediary who is precluded from reporting pursuant to a legal professional privilege (“L.P.P.”) must inform in writing any other intermediary or the relevant taxpayer of the fact that the reporting obligation shifts to them. However, the L.P.P.-exemption does not apply for the reporting of marketable arrangements. The question arises whether the Belgian Constitutional Court will accept this restrictive interpretation of the L.P.P.<sup>111</sup> Several Belgian Bar and attorney associations introduced annulment procedures before the Belgian Constitutional Court to request the annulment of the Law.

As of May 30, 2022, the Belgian Constitutional Court requested a preliminary ruling from the E.C.J.<sup>112</sup> The request for a preliminary ruling concerns the compatibility of the Directive with Article 7 (right to respect for private life) and Article 47 (right to a fair trial) of the Charter of Fundamental Rights of the E.U. insofar as it requires legal counsel to notify other intermediaries of a need to report under D.A.C.6. Awaiting the ruling from the E.C.J., the proceedings before the Belgian Constitutional Court are suspended.

## COVID-19 TAX MEASURES

In the wake of the lockdown and travel restrictions imposed during the C.O.V.I.D.-19 pandemic, Belgium adopted several emergency measures to alleviate the financial strains on Belgian corporate taxpayers. The Commission indicated on March 13, 2020, that such measures fall outside the scope of State Aid. In other words, Member States can take appropriate measures without the involvement of the Commission or the risk of such measures being struck down afterwards on the basis that they constitute non-permissible State Aid.

In Belgium, the measures included the following:

- The deferral of tax payments and filing deadlines for V.A.T., wage W.H.T., resident and nonresident C.I.T., resident and nonresident personal income tax, and legal entities tax
- The deferral of tax audits
- Higher tax credits for C.I.T. prepayments
- Flexibility of the E.B.I.T.D.A. grandfathering rule
- Write-downs on trade receivables
- The loss carryback light<sup>113</sup>

<sup>111</sup> See W. Heyvaert and V. Sheikh Mohammad, “*Secret professionnel de l’avocat et D.A.C. 6 - une conciliation (im)possible ?*” *Journal de droit fiscal*, 2019, No 11, pp. 321-329; L. Vanheeswijck, “*D.A.C. 6: het einde van het beroepsgeheim in fiscale zaken?*” *Tijdschrift voor fiscaal recht*, 2019, n° 560, p. 377.

<sup>112</sup> E.C.J., *Orde van Vlaamse Balies and Others v. Vlaamse Regering*, Case C-694/20, December 21, 2021, available [here](#).

<sup>113</sup> See [Belgian Circular Letter 2020/C/122 of September 22, 2020](#); [Advice of the Belgian Accounting Standards Committee 2020/11 of September 9, 2020](#); J. Permeke and M. Krug, “The Loss Carry-Back Regime and the Reconstitution Reserve,” *Tijdschrift Beleggingsfiscaliteit*, 2020, No 14, pp. 13-39.

- The tax-free reconstruction reserve<sup>114</sup>
- The bilateral agreements about residency for cross-border workers, that treated days worked from home as days worked from the typical place of business<sup>115</sup>

As of May 30, 2022, most of these measures have either been withdrawn or are being phased out.




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<sup>114</sup> See W. Heyvaert and V. Sheikh Mohammad, [“Belgium’s Latest Fiscal Response to the Economic Slump Caused by the COVID-19 Pandemic – A New Reconstitution Reserve for Belgian Corporate Taxpayers.”](#) *AKD Newsflash*, December 7, 2020.

<sup>115</sup> See W. Heyvaert and V. Sheikh Mohammad, [“COVID-19 & Taxation of Cross-Border Employees: Belgium Extends Mutual Agreements with the Netherlands, Luxembourg, France and Germany Through 31 March 2022.”](#) *AKD Newsflash*, December 22, 2021.

## SWEDEN

### Author

Erik Nilsson  
Svalner Skatt&Transaktion  
Stockholm

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### IN GENERAL

Sweden has emerged as an attractive country for establishing financing and holding companies for both E.U. and non-E.U. corporations. However, modifications in recent years, e.g., intra-group interest restrictions, have affected this status adversely, although perhaps no more adversely than other countries that have implemented O.E.C.D (B.E.P.S.) and E.U. measures on tax avoidance. The key features of the Swedish holding company regime 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 90 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains;
- a low corporation income tax rate (*i.e.*, 20.6%);
- relatively low requirements on minimum share capital – SEK 25,000 (approx. €2,500); 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 20.6%. 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. Under chapter 24 of the Swedish Income Tax Act (“I.T.A.”), the holding entity must be in one of the following forms in order to qualify:

- A Swedish A.B. or a Swedish economic association that is not an investment company
- A Swedish foundation or a Swedish non-profit association that is not subject to tax exemption according to chapter 7 I.T.A.
- A Swedish savings bank
- A Swedish mutual insurance company
- A foreign company resident within the E.E.A. that is the equivalent of any of the foregoing entities

The term “foreign company” is defined in the I.T.A. as a foreign legal entity that is subject to tax in its country of residence, provided such taxation is similar to the taxation of a Swedish A.B. In general, a tax charge of at least 10% should be acceptable. Also, a foreign legal entity resident in a country with which Sweden has signed a double tax treaty is always deemed a “foreign company” if the entity is entitled to the benefits of the treaty and the treaty is not limited to certain types of income.

The share held must be a share in an AB, an economic association, or a similar foreign entity. This is discussed below **Qualifying Foreign Entities**. The share must also be a capital asset, generally defined as assets other than trading stock, inventory, work-in-progress, receivables and similar assets, equipment, patents, and other intangibles. Additionally, the share must meet at least one of the following criteria:

- The share is not listed.
- The holding entity owns shares representing at least 10% of the total number of votes of the company.
- The holding is deemed necessary for the business conducted by the owner or any other company within the community of interests of the owner.

If both the holding entity and the subsidiary fulfill the abovementioned conditions, the shares held are deemed “business-related shares,” and thus qualify under the participation exemption.

### **Dividends**

In general, dividends received from business-related shares are tax exempt. If the shares are listed, they must be held for a period of at least one year from the time when the shares became business-related for the holding entity. Also, dividends on shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

The foregoing is subject to an exception, generally provided for in the B.E.P.S. Action Plan and E.U. directives combating tax abuse. Dividends received from foreign companies are taxable if the dividend may be deducted by the payor, such as in the case of an interest expense payment or some similar expense.

## **Capital Gains**

Capital gains on the disposal of business-related shares are tax exempt. Accordingly, capital losses derived from the disposal of those shares are not tax deductible. If the shares are listed, the capital gains are tax exempt provided that the shares have been deemed business-related with regard to the seller for at least one year immediately preceding the disposal.

Capital gains arising from the disposal of an interest in a Swedish partnership or a foreign tax-transparent entity resident within the E.E.A. are tax exempt if the interest is owned by a company qualified for holding business-related shares. Also, capital gains arising from shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

## **Qualifying Foreign Entities**

Shares in foreign legal entities may also qualify as business-related shares if the legal entity corresponds to a Swedish limited liability company. The relevant provisions in the I.T.A. do not state what conditions should be met in order for a foreign legal entity to correspond to a Swedish A.B. In a case regarding a Russian limited liability company (“O.O.O.”), the Supreme Administrative Court based its decision mainly on the resemblance, from a civil law perspective, between a Russian O.O.O. and a Swedish limited liability company. In addition, the O.O.O. in question was subject to income tax in Russia. Therefore, it was deemed to correspond to a Swedish limited liability company. In another case regarding a Lichtenstein *Anstalt*, the Supreme Administrative Court held that the circumstance that income may be tax-free in the company’s state of residence does not affect the determination of whether the company is fully taxable. The Supreme Administrative Court stated that only if the company is subject to a general and complete exemption from income taxation in the home country, the shares would be disqualified from being business-related. So far, a large number of foreign legal entities have been deemed to correspond to Swedish A.B.’s by the Supreme Administrative Court and the Board for Advance Tax Rulings.

# **WITHHOLDING TAX**

## **Outbound Dividends**

Under the Swedish Withholding Tax Act (“W.T.A.”), a 30% withholding tax is levied upon the distribution of dividends by a Swedish A.B. However, due to the implementation of the E.U. Parent-Subsidiary Directive (“P.S.D.”) and Sweden’s extensive network of double tax treaties, withholding tax will not be imposed or will be imposed at a reduced rate in most cases. Under the double tax treaty concluded between the U.S. and Sweden, for instance, Sweden may not impose withholding tax on dividends if the U.S. holding in the Swedish company amounts to at least 80% of the votes and has been in place for at least one year. If the size of the holding is below 80% but 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.

Exemption also applies to dividends distributed to a foreign contractual fund. In addition, certain funds are exempted from withholding tax when the funds are within (i) the E.E.A. or (ii) a country with which Sweden has in effect a comprehensive income tax treaty or a tax information exchange agreement.

## **Inbound Dividends**

Withholding tax on distributions from foreign subsidiaries is often eliminated under the P.S.D. or reduced under a double tax treaty, as shown below in the treaty chart below.

## **Treaty Chart**<sup>1</sup>

Sweden currently has over 90 double tax treaties in effect, in addition to a vast number of tax information exchange agreements (“T.I.E.A.’s”). Double tax treaties are in effect with the following jurisdictions:

Albania	Czech Republic	Kenya	Singapore
Argentina	Denmark	Kosovo	Slovakia
Armenia	Egypt	Latvia	Slovenia
Australia	Estonia	Lithuania	South Africa
Austria	Faeroe Islands	Luxembourg	South Korea
Azerbaijan	Finland	Macedonia	Spain
Bangladesh	France	Malaysia	Sri Lanka
Barbados	Gambia	Malta	Switzerland
Belarus	Georgia	Mauritius	Taiwan
Belgium	Germany	Mexico	Tanzania
Bermuda	Guernsey	Montenegro	Thailand
Bolivia	Hungary	Namibia	Trinidad & Tobago
Bosnia & Herzegovina	Iceland	Netherlands	Tunisia
Botswana	India	New Zealand	Turkey
Brazil	Indonesia	Nigeria	Ukraine
Bulgaria	Ireland	Norway	U.K.
B.V.I.	Isle of Man	Pakistan	U.S.A.
Canada	Israel	Philippines	Venezuela
Cayman Islands	Italy	Poland	Vietnam
Chile	Jamaica	Romania	Zambia
China	Japan	Russia	Zimbabwe
Croatia	Jersey	Saudi Arabia	
Cyprus	Kazakhstan	Serbia	

<sup>1</sup> The treaty concluded between Sweden and the former Kingdom of Yugoslavia remains applicable to the present-day republics of Bosnia & Herzegovina, Croatia, Kosovo, Montenegro, Slovenia, and Serbia.

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

## FINANCING

### Loan Financing

As a rule, interest payments are deductible. However, Sweden has general interest deduction limitation rules based on the Anti-Tax Avoidance Directive (“A.T.A.D.”) and B.E.P.S. Action Item 4. Under the general limitation rule, deduction is limited to net interest expense corresponding to 30% of the company’s E.B.I.T.D.A. The general limitation applies to all debt.

In addition, a deduction is not allowed to a Swedish borrower for interest on intra-group debt unless the creditor within the group (i) is taxed on the interest income at a rate of at least 10% or (ii) is domiciled within the E.E.A. or within a country with which Sweden has a tax treaty in effect. Regardless, a deduction may be refused if the debt structure has been put in place exclusively or almost exclusively for the group to achieve a substantial tax benefit.

Interest may not be deducted on hybrid mismatch lending transactions. The rules apply to interest payable to a foreign company with which the Swedish company has a community of interest, and where the foreign company is not taxed on the interest income due to a difference in legal classification of the payment.

Sweden does not impose withholding tax on interest payments.

From a transfer pricing perspective, the interest rates charged must be at arm’s length. Interest rates charged between related parties may be – and most often are – challenged by the Swedish Tax Agency (“S.T.A.”).

### Equity Contributions

In addition to traditional equity investments, under Swedish law, there are two types of shareholders’ contributions available: conditional and unconditional contributions.

An unconditional contribution is a final investment in the company, without a claim for future repayment. An unconditional contribution is not deemed to be taxable income for the receiving company. However, it indirectly leads to a deductible expense for the contributor, since the contribution is added to the tax basis of the shares and is thus deductible when calculating future capital gains or losses – if the investment is a taxable investment – on the disposal of the shares.

A conditional contribution is deemed to be a loan for tax purposes. Repayment of a conditional contribution is not regulated in Swedish tax law, but according to case law, a repayment is generally treated as the repayment of a loan and, thus, is not a taxable event, unless special circumstances are at hand.

Sweden does not impose any transfer tax or stamp duty on equity contributions.



## LIQUIDATION

### Distributions

Under the I.T.A., the liquidation of a company is deemed a taxable disposal of the shares issued by the liquidated company. Thus, an individual shareholder is normally taxed on the difference between the amount distributed during the liquidation and the tax basis in the shares. If the shares are business-related shares, no capital gains or losses will be recognized. For foreign shareholders, a distribution in connection with the liquidation of a company is deemed to be a distribution of a dividend. Thus, withholding tax will be levied on the distributed gross amount unless domestic or treaty rules provide otherwise. If the company is dissolved within two years of the distribution, the shareholder's acquisition value for the shares may be deducted. The taxpayer will receive a refund of the amount of withholding tax paid which exceeds the amount of tax imposed on the difference between the distributed amount and the acquisition value. However, as mentioned above, withholding tax will be eliminated in most cases or imposed at a reduced rate.

### Losses

Final losses on the liquidation of foreign subsidiaries give rise to a special group deduction ("*koncernavdrag*"). The deduction is a result of Sweden becoming an E.U. Member State. However, it applies in very restricted circumstances. For a deduction to be claimed, all of the following conditions must be met:

- The foreign subsidiary must be located within the E.E.A.
- The foreign subsidiary must be liquidated.
- Until the liquidation is completed, the foreign subsidiary must have been wholly owned either during the entire fiscal year of both the parent and the subsidiary, or since it started conducting business of any kind.
- The deduction of the group contribution must be made in connection with the tax assessment of the fiscal year during which the liquidation is completed.
- The deduction of the group contribution must be openly disclosed in the tax assessment of the parent company.
- None of the companies within the parent company's community of interests may conduct business in the domicile state of the subsidiary after the completion of the liquidation.

A loss is considered final only if the subsidiary, or another entity in the domicile state of the subsidiary, has not utilized the loss and will not be able to utilize it in the future. If the loss is not utilized because the law of the domicile state does not provide for such a possibility or because such a possibility is limited in time, the loss will not be considered final.

There are also limitations to the amount that may be deducted. The deduction may not exceed the loss of the foreign subsidiary at the end of the last complete fiscal year before the end of the liquidation or before the liquidation. The deduction may not exceed the positive result of the parent company before the deduction. When calculating the result of the parent company, any group 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 group contributions, *i.e.*, value transfers that are deductible for the payer and income for the recipient, are not allowed until the sixth year following the year in which the loss company was acquired. These restrictions do not apply to group internal restructurings.

The above applies only to N.O.L.’s incurred during past fiscal years. N.O.L.’s incurred during the current fiscal year – the year of acquisition – are not subject to any restriction.

*“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 €14,000 on June 25, 2022). The agreement is normally valid for three to five taxable years.

As is the case in other countries, the S.T.A. has increased its focus on transfer pricing matters in recent years. It is likely that the abovementioned rules will be modified as a result of the O.E.C.D.’s initiative to combat base erosion and profit shifting (the “B.E.P.S. Project”) and there is a clear trend that the S.T.A. will be more aggressive in challenging intercompany pricing and transactions. Accordingly, the S.T.A. will likely further enhance its focus on intercompany transactions and the requirements for documentation and information from the taxpayer. Additional comments on B.E.P.S. will be made separately below under **B.E.P.S.**

## CONTROLLED FOREIGN CORPORATIONS

The purpose of the Swedish controlled foreign corporation (“C.F.C.”) rules is to prevent Swedish persons or companies from deferring or avoiding taxation by collecting

funds in a foreign subsidiary resident in a low tax jurisdiction. If a foreign subsidiary is deemed to be a C.F.C., a shareholder subject to tax in Sweden will be taxed directly for an appropriate share of the C.F.C.'s profit – as calculated under Swedish generally accepted accounting principles and tax rules, irrespective of whether any funds have been distributed. Any tax paid in the foreign jurisdiction is creditable against Swedish tax.

In order for the C.F.C. rules to be applicable, the foreign corporation must be subject to low tax, which is defined as a tax rate lower than 55% of the Swedish corporate tax rate, which is 11.055% at current Swedish tax rates as of May 30, 2022. To be subject to C.F.C. taxation, the controlling entity must own or control shares representing at least 25% of the capital or votes of the foreign corporation alone or together with persons with which a communal interest exists.

There are two exceptions to the C.F.C. rules. The first exception is that, regardless of the level of taxation, a foreign legal entity will not be considered to be a C.F.C. if it is resident for tax purposes in a country mentioned on the so-called “whitelist” of countries. If Sweden has concluded a double tax treaty with a whitelisted country, the exception from the C.F.C. rules applies only to income that falls within the scope of the treaty. The second exception is that the C.F.C. rules do not apply to a corporation that is resident for tax purposes within the E.E.A. and is deemed to be a real establishment from which a commercially motivated business is conducted.

## **B.E.P.S.**

Sweden has slowly taken an increased interest in combatting B.E.P.S. and in the development of the B.E.P.S. Project at the level of the O.E.C.D.

The B.E.P.S. Project initially had only an indirect effect in Sweden. This changed in 2019 when the Swedish government implemented major changes to the I.T.A. concerning corporate income tax, as explained above in **Loan Financing**, regarding interest expense deductions.

Beyond the B.E.P.S. related legislation, it is clear that the S.T.A. is learning from the analysis and comments made by different parties, and it is expected that the S.T.A. and its Nordic counterparts will become more active in issues concerning permanent establishments, transfer pricing, and intercompany transactions. Information exchange – whether as a result of B.E.P.S., F.A.T.C.A., or the Common Reporting Standard (“C.R.S.”) – will also trigger more activities. Long term, it is assumed that the B.E.P.S. Project will trigger an increased documentation and compliance burden for taxpayers, but not necessarily much new legislation or changes to the I.T.A. It is important to keep in mind that many of the B.E.P.S. Actions will not require an actual change of law by the Swedish Parliament. Rather, changes in O.E.C.D. Guidelines will affect the customary points of reference utilized by the S.T.A. and will be implemented in judicial decisions. In this context, legislators in most countries have been driven by media attacks on the tax planning methods of multinational groups, and the likely effect is that more “double taxation” will occur in order to prevent “double nontaxation.”



## RISK TAX ON CREDIT INSTITUTIONS

As of January 1, 2022, Sweden has adopted a new risk tax for credit institutions. The law is applicable on credit institutions with a total debt that exceeds SEK 150 billion (approximately €14 billion as of June 25, 2022) at the beginning of the fiscal year. The limit will be indexed yearly for coming fiscal years.

The taxable amount is the sum of the credit institution's total debt at the beginning of the fiscal year. However, certain debt categories, such as intra-group debt, are not included in the calculation.

The tax rate is 0.05% for fiscal year 2022, which will be increased to 0.06% for fiscal years beginning in or after 2023.





# DENMARK

**Author**  
Arne Riis  
BDO Denmark  
Copenhagen

## 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 the following:

- 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)
- 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 the following:

- 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, as discussed below at **Capital Gains Taxation**
- 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)
- A flexible corporation law regime with no red tape

On the other hand, some Danish rules discourage or hamper investments, such as the following:

- 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 (earnings-stripping rules), in particular, international tax planning strategies involving U.S.-Danish check-the-box structures, and in general, hybrid entities and loans
- 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”), as discussed below at **Tightening of the Rules for Dividend Withholding Tax Exemption**
- A broadly worded general anti-abuse rule (principal purpose test (“P.P.T.”)) the application in practice of which is still subject to considerable uncertainty

## 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, as discussed below at **Group of Companies – Joint Cross-Border Taxation**, 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 taxes may be reduced (but not increased) under a relevant double tax treaty. No local income taxes are levied by cities or regions on companies or branches in Denmark.

## COVID-19 – MEASURES ON INTERNATIONAL DOUBLE TAXATION

On July 3rd, 2020, the Danish tax authorities (“*Skattestyrelsen*”) issued guidance on the ways in which the double tax conventions are influenced in respect to permanent establishment and place of effective management due to the COVID-19 pandemic.

The guidance builds on the O.E.C.D. pronouncement issued on April 3, 2020.

It is the general assessment of the Danish tax authorities that the temporary limitations imposed on the mobility of individuals due to measures against COVID-19 implemented or recommended by individual countries should not result in the emergence of permanent establishments in the country where a stranded individual is forced to remain temporarily, assuming no permanent establishment already exists in that country. Thus, in determining the period of presence in a country that is otherwise a threshold for the existence of a permanent establishment, time spent during lockdown or quarantine should not be taken into account, according to the Danish tax authorities. Emphasis is placed on the following:

- The situation being temporary, driven by demands or recommendations from the local authorities, which are outside the company’s control
- The changed circumstances are not due to the employer’s business activity and will not result in the normal place of work being at the employer’s premises

Similar considerations apply when determining if a dependent agent rises to the level of a permanent establishment under paragraph 5 of Article 5 (Permanent Establishment) of the O.E.C.D. Model Tax Convention. Where a dependent agent carries out activity in a jurisdiction (the first jurisdiction) other than where permanently based (the second jurisdiction), and the activity is extraordinary and temporary, a permanent establishment will not be deemed to exist in the first jurisdiction merely because of the extraordinary and temporary activity.

Where two countries disagree on the tax residence of a company, usually the determining factor is the location of the actual management of the company. Where, following travel restrictions brought on by COVID-19, management executives employed by a company that is tax resident in one country are stranded in a second country, the position of the Danish tax authorities is that the extraordinary and temporary change in the management situation should be ignored when determining the place of management if it is solely a consequence of COVID-19 travel restrictions. Hence, the company should not be considered as having relocated its place of effective management in the context of a double tax convention.

## 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.

*“On July 3rd, 2020, the Danish tax authorities issued guidance on the ways in which the double tax conventions are influenced in respect to permanent establishment and place of effective management due to the COVID-19 pandemic.”*

As of May 31, 2022, Denmark has income tax treaties in effect with the following jurisdictions:

Argentina	Egypt	Kenya	Serbia
Armenia	Estonia	Kuwait	Singapore
Australia	Faeroe Islands	Kyrgyzstan	Slovakia
Austria	Finland	Latvia	Slovenia
Azerbaijan	Georgia	Lithuania	South Africa
Bangladesh	Germany	Luxembourg	South Korea
Belarus	Ghana	Macedonia	Sri Lanka
Belgium	Greece	Malaysia	St. Martin
Bermuda	Greenland	Malta	Sweden
B.E.S. Islands	Guernsey	Mexico	Switzerland
Brazil	Hungary	Montenegro	Taiwan
Bulgaria	Iceland	Morocco	Tanzania
B.V.I.	India	Netherlands	Thailand
Canada	Indonesia	New Zealand	Tunisia
Cayman Islands	Ireland	Norway	Turkey
Chile	Isle of Man	Pakistan	Uganda
China	Israel	Philippines	Ukraine
Croatia	Italy	Poland	U.K.
Curaçao	Jamaica	Portugal	U.S.A.
Cyprus	Japan	Romania	Vietnam
Czech Republic	Jersey	Russia	Zambia

A new double tax treaty between Denmark and France has been signed. As of June 25, 2022, it is not known when the new tax treaty will come into effect. The expectation is that the treaty will likely be effective from January 1, 2023.

Denmark has concluded limited tax information exchange agreements (“T.I.E.A.’s”) with the following jurisdictions:<sup>1</sup>

Andorra	Brunei	Liechtenstein	San Marino
Anguilla	Cook Islands	Macao	Seychelles
Antigua & Barbuda	Costa Rica	Marshall Islands	St. Kitts & Nevis
Aruba	Dominica	Mauritius	St. Lucia
Bahamas	Gibraltar	Netherlands Antilles	St. Vincent & Grenadines
Bahrain	Grenada	Niue	Turks & Caicos
Barbados	Guatemala	Panama	Vanuatu
Belize	Hong Kong	Qatar	
Botswana	Liberia	Samoa	

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

<sup>1</sup> The T.I.E.A. with Guatemala is not in force.

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 ratified the convention. Denmark has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, and it is in full force and effect.

## CORPORATE TAXATION OF INBOUND DIVIDENDS

Dividends received from a foreign subsidiary are generally exempt from Danish corporation income tax if the following three 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, which means 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

- carries on business for profit,
- has a fixed share capital,
- provides limited liability for all its shareholders, and
- 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 generally 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 C.F.C. taxation applies in the form of mandatory joint taxation of a Danish company that holds a qualifying interest in any Danish or foreign C.F.C. entity. In this context, mandatory joint taxation means that the controlled company’s net income, if positive, will be included in the taxable income of the Danish parent company. If the



controlled company is not wholly owned by the Danish parent company, the Danish parent company will include a proportionate share of the controlled company's income corresponding to its ownership share.

The Danish C.F.C. regime has been implemented according to the C.F.C. provisions of the A.T.A.D.

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

- The Danish parent company controls the foreign company, which generally means that the Danish parent company either directly or indirectly (i) controls more than 50% of the voting rights in the foreign company, (ii) holds more than 50% of the share capital, or (iii) has a right to receive more than 50% of the profit.
- The C.F.C. income of the foreign company exceeds one-third of the aggregate taxable income of the foreign company.
- The group has not chosen international joint taxation under section 31A of the Corporate Income Tax Law.
- The Danish parent company's shares in the foreign company are not shares or investment certificates in investment companies, or shares held through such investment companies as defined under section 19 of the Law on Taxation of Capital Gains on Shares.

If Danish cross-border tax consolidation has been elected by the group, the C.F.C. rules do not apply.

C.F.C. income is defined by law to include the following categories of income:

1. Net interest income
2. Net gains on receivables, debts, and financial instruments
3. Income from intellectual property
4. Taxable dividends
5. Net taxable capital gains on shares
6. Deductions for tax purposes that relate to the income of items 1 through 5 above
7. Leasing income derived from financial leasing, including losses and gains on such assets
8. Insurance, banking, and other financial activities
9. Income from billing companies that have income from goods and services which are bought and sold to affiliated persons or entities and which contribute little or no substantial financial value to the C.F.C.

If the above conditions are met, the resident parent company is taxed on a share of the nonresident company's net income equal to the parent's average direct or indirect influence in the foreign company during the tax year concerned, based on

***“The substance test should be interpreted in accordance with the E.U. anti-abuse rule, which examines whether the foreign company has sufficient substance based on case law from the E.C.J.”***

the factors that cause the foreign company to be a C.F.C. If the foreign company has only been controlled by the Danish company for a part of the income tax year concerned, then only the income corresponding to the ownership period will be included.

Income from intellectual property is generally included in the C.F.C. income, and is divided into

- payments that are received as compensation for the use of or the right to use an intellectual property right and gains from the sale of intellectual property (section 32(5), no. 3, *litra* a of the S.E.L.); and
- all other income from intellectual property (section 32(5), no. 3, *litra* b of the S.E.L.).

All other income from intellectual property (“embedded royalty”) includes all income that cannot be covered by section 32(5), no. 3, *litra* a. The inclusion of embedded royalty in C.F.C. income means that all income from intangible assets is included in the C.F.C. income no matter how the intangible income is manifested. Thus, embedded royalty income includes income from intangible assets realized through the sale of goods and/or services when the sale price includes an embedded royalty return on the intangible assets.

However, embedded royalty may only be included in the C.F.C. income if the foreign company does not carry out a substantial valuable activity regarding the creation of the intellectual property. This is determined by examining personnel, equipment, assets, and facilities, *i.e.*, the substance test.

The substance test should be interpreted in accordance with the E.U. anti-abuse rule, which examines whether the foreign company has sufficient substance based on case law from the E.C.J. Whether there is sufficient substance in relation to the ownership of the intellectual property generally is determined based on the foreign company’s activity, functions, capital, and control of risks compared to the intellectual property’s value, stage of development, properties, and scope of use.

Where more than one affiliated company exists in the same jurisdiction, the substance test is based on the activity of all companies in the country. They are looked at as a whole in relation to the intellectual property.

The substance test is not met if the foreign company owns and carries out sales and distribution functions in relation to its intellectual property, but the remaining substantial functions in relation to the intellectual property are only carried out in a non-substantial degree in the jurisdiction where the foreign company is registered. In that case, the income from intellectual property will be included in the C.F.C. income, regardless of whether the foreign company has financed the investment in the intellectual property.

Lastly, the substance test is not met if the foreign company is registered in a state that has not entered into an agreement for the exchange of information or similar with Denmark, except where the intellectual property is essentially created through research and development carried out by the foreign company or an affiliated company in the same jurisdiction.

The parent company must actively choose to apply the substance test within the deadline for submission of its tax return. If the parent company does not timely choose to apply the substance test, all other income from intellectual property will be included in the C.F.C. income. The choice is made on an annual basis and in certain cases may only be undone for a particular tax year.

Where the substance test is applied, the parent company must submit C.F.C. documentation proving that the foreign company's other income from the intellectual property is covered by the substance test. The documentation must be submitted to the Danish tax authorities no later than 60 days after the deadline for submission of its tax return.

## 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 generally are 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 from the sale of 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 following two conditions are met:

- 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. In other words, the transaction does not embody a share-for-share exchange.
- The transferor foreign entity would not have qualified for exemption from Danish withholding tax on dividends received from the transferred Danish entity prior to the transfer.<sup>2</sup>

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.

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<sup>2</sup> 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 between controlled parties as dividend income.



Additionally, an anti-avoidance rule mandates that payments received by a foreign entity in connection with a transfer of shares will be considered a taxable dividend payment if the following three conditions are met:

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

In order to prevent circumvention of the anti-avoidance rule through intercompany sales, commercial activity acquired from a related legal entity within the three-year period preceding 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 €1,344,249 as of May 31, 2022). The thin capitalization rules apply only if, and to the extent, 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 (i) is controlled by the Danish Debtor, (ii) controls the Danish Debtor, or (iii) is group-related with the Danish Debtor.

“Control” means ownership or direct or indirect control of more than 50% of the shares or voting rights of the company issuing the shares. 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 applied in the order listed:

- A limitation based on debt-to-equity ratio (the thin capitalization rules), already discussed above at **In General**
- A limitation based on the tax value of assets (“Asset Limitation Rule”), entailing that net financing expenses exceeding DKK 21,300,000 (approximately €2,863,250 as of May 31, 2022) are deductible up to a cap of 2.2% (2022 figure) of the tax basis of the Danish operating assets, discussed in **Calculation of Net Financial Expenses and Excess Debt Funding Costs**, below
- A limitation based on annual profits (“E.B.I.T.D.A. Limitation Rule”), entailing a maximum interest deduction of 30% of E.B.I.T.D.A., which only applies if the excess debt funding costs exceed DKK 22,313,400 (approximately €2,999,476 as of May 31, 2022), discussed in **Restrictions Under the Asset Limitation Rule**, below

### **Calculation of Net Financial Expenses and Excess Debt Funding Costs**

For the purposes of the Asset Limitation Rule, net financial expenses are calculated as the sum of the following items:

- Taxable interest income and deductible interest expense, excluding interest income/expense from/to trade debtors and creditors
- Loan commission fees and similar expenses

- Taxable capital gains and losses on claims, debts, bonds, and financial instruments, excluding gains/losses on claims acquired in trade if the contracting party is a related party
- Gains/losses on forward contracts relating to the hedging of operating income, provided that the forward contracts are not acquired in trade
- Deemed finance charges relating to financial leasing arrangements, as defined in accordance with I.A.S. 17)
- Taxable capital gains and deductible capital losses
- Taxable dividends
- For the purpose of the E.B.I.T.D.A. Limitation Rule, Excess debt funding costs include each of the following items:
  - Taxable interest income and deductible interest expense, excluding interest income/expense from trade debtors and creditors
  - Loan commission fees and similar expenses
  - Taxable capital gains and losses on claims, debts, bonds, and financial instruments, excluding gains/losses on claims acquired in trade if the contracting party is a related party
  - Gains/losses on forward contracts relating to the hedging of operating income, provided that the forward contracts are not acquired in trade
  - Deemed finance charges relating to financial leasing arrangements, as defined in accordance with I.A.S. 17)

Interest expense and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses and the excess debt funding costs. The calculation of net financial expenses and excess debt funding costs is made on a group basis for Danish companies, which are subject to Danish tax consolidation. If the Danish company/group has net financial expenses exceeding the DKK 21,300,000 threshold (or as regards excess debt funding costs; DKK 22,313,400), such net financial expenses will be subject to restrictions under the Asset Limitation Rule and/or the E.B.I.T.D.A. Limitation Rule, as applicable, as discussed below.

### **Restrictions Under the Asset Limitation Rule**

Net financial expenses in excess of DKK 21,300,000 (approximately €2,863,250 as of May 31, 2022) will be deductible only in an amount corresponding to 2.2% (2022) of the tax value of certain assets.

For the purposes of computing the 2.2% 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

*“In comparison to the Asset Limitation Rule, excess debt funding costs that are restricted by the E.B.I.T.D.A. Limitation Rule may be carried forward.”*

- 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 2.2% ceiling. For companies subject to Danish tax consolidation, the computation of the 2.2% ceiling is made on a consolidated basis.

The tax benefit of net financing expenses that are restricted under the Asset Limitation Rule are lost; they cannot be carried forward for use in a subsequent period. 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.

### **Restrictions Under the E.B.I.T.D.A. Rule**

In addition to the limitations triggered by the thin capitalization rules and the Asset Limitation Rule, a company's or a group's excess debt funding costs must not exceed more than 30% of earnings before interest, tax, depreciation and amortization (“E.B.I.T.D.A.”).

Excess debt funding costs below DKK 22,313,400 (approximately €2,999,476 as of May 31, 2022) will never be restricted under the E.B.I.T.D.A. Limitation Rule, but may be restricted under the Asset Limitation Rule or the thin capitalization rule previously discussed. The DKK 22,313,400 ceiling is not adjusted annually. It is calculated on a groupwide basis for Danish companies that are subject to Danish tax consolidation.

In comparison to the Asset Limitation Rule, excess debt funding costs that are restricted by the E.B.I.T.D.A. Limitation Rule may be carried forward.

The 30% restriction is subject to a modification that applies when a Danish company or group is part of a group and the consolidated net financing expenses of the group as divided by the consolidated E.B.I.T.D.A. of the group is higher than 30%. In such case a corresponding higher percentage applies to determine the deductibility restriction under the E.B.I.T.D.A. Limitation Rule. Both the consolidated E.B.I.T.D.A. and the net financing expenses must be determined on the basis of an audited annual report which is prepared in accordance with the Danish Financial Statements Act (“årsregnskabsloven”)

## **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 withholding tax is levied. The withholding tax rate is (i) 27% is levied, subject to a subsequent refund of 5 percentage points for any corporation, irrespective of location or (ii) a lower rate provided by applicable treaty. The net 22% general tax rate on dividends may be

reduced where a tax information exchange agreement has been entered into with the residence jurisdiction of the shareholder. In those cases, Denmark refunds withholding tax down to an effective rate of 15%.

## 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 that do not qualify under the P.S.D. or that are resident in a state outside the E.U. that has in effect an income tax treaty with Denmark. The U.S. would be an example of a country that is affected by this provision.

## TAXATION OF PAYMENTS TO NON-COOPERATIVE TAX JURISDICTIONS

In the Spring of 2021, the Danish Parliament passed legislation that sets out defensive measures against payments to countries on the E.U.’s list of noncooperative tax jurisdictions. Deductible or depreciable payments are nondeductible and non-depreciable for tax purposes where the beneficial recipient of the payment is a tax resident of any of the following jurisdictions:

- American Samoa
- The U.S. Virgin Islands
- Fiji
- Guam
- Palau
- Panama



- Samoa
- Trinidad & Tobago
- Vanuatu

Further, outbound dividends will be subject to a dividend withholding tax of 44% where the beneficial owner of the shares is a tax resident of one of the above jurisdictions or the owner is a company in which the majority shareholder is a resident of a blacklisted jurisdiction or is controlled by a resident of a blacklisted jurisdiction.

## BASE AND EROSION PROFIT SHIFTING

Denmark has already implemented many B.E.P.S. Actions in Danish law and accordingly is 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** discussing §2A of the Danish Corporation Tax Act, which is intended to counteract U.S.-Danish check-the-box structures. Section 2A was repealed on the January 1, 2019, with effect from 1 January 2020.

With respect to Action Item 3, see **C.F.C. Taxation**. 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**. 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 Clause**, which outlines the contents of the Danish general anti-abuse clause. The scope of their implementation and application is not yet clear.

With respect to Action Items 8, 9, and 10, see **Transfer Pricing** 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 CLAUSE

Since 2015, Denmark has had in effect two general anti-abuse rules ("G.A.A.R.'s"): one is an E.U. tax directive G.A.A.R. and the other is 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 ("I.R.D.")

(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. for the P.S.D. (amendment by Directive 2015/121/E.U.).

The tax treaty G.A.A.R. is worded slightly differently from the E.U. tax treaty G.A.A.R., but presumably will be interpreted to have the same effect. With the enactment of the tax treaty G.A.A.R., Denmark has moved ahead of B.E.P.S. Action 6.

As of January 1, 2019, the E.U. tax directive G.A.A.R. was replaced by a broader general anti-abuse rule which implements G.A.A.R. set out in the A.T.A.D., and which applies to both domestic and cross-border arrangements.

The G.A.A.R.'s generally provide that taxable persons will not benefit from Danish domestic tax rules, the P.S.D., the I.R.D., the Merger Directive, and tax treaties if (a) the principal purpose of a transaction or arrangement is to achieve a tax benefit which is not in accordance with the relevant tax rules, the directives, or the tax treaty and (b) the transaction or arrangement is artificial in nature.

Thus far, the Danish courts have applied certain measures to disregard transactions carried out for tax purposes, adopting a substance over form approach.

The explanatory remarks accompanying both the bill introducing the initial E.U. tax directive G.A.A.R. and the tax treaty G.A.A.R. as well as the most recent A.T.A.D. G.A.A.R. are quite vague and general in nature, and fail to specify in which situations the G.A.A.R.'s are applicable.

The 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 Danish domestic rules, 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.

As a potential “safety measure” to protect the taxpayers against random application of the G.A.A.R.'s in any given situation, the most recent 2019 amendment to the G.A.A.R. provide that the Danish tax authorities must submit for approval any proposed amendment to the relevant tax assessment based on applying the G.A.A.R., to the Danish tax council (“*Skatterådet*”), prior to applying the G.A.A.R. in any given situation. The *Skatterådet* is a semi-independent administrative decision body within the Danish tax administration. The extent to which the *Skatterådet* will act as a true gate keeper to advance legal certainty remains to be seen.

## INTEREST WITHHOLDING TAX AND CHECK-THE-BOX COUNTERMEASURES

Section 2A of the Danish Corporation Tax Act has effectively been replaced by the hybrid mismatch rules.

With effect from January 1, 2020, §8D and §8E of the Danish Corporation Tax Act regarding double dip arrangements are part of Danish tax law. They implement the anti-hybrid rules in the E.U. A.T.A.D. Directives I and II.





- Companies with tax residence in Denmark cannot deduct expenses if a hybrid mismatch leads to a double deduction arrangement. Where the arrangement does not lead to a deduction in the other country because, for example, the deduction is denied by the tax authorities of that other country, the Danish hybrid mismatch rule is no longer applicable to the transaction
- Companies with tax residence in Denmark cannot deduct expenses on payments to a permanent establishment based in another state if the permanent establishment is not required to include the payment in its taxable income under the laws of the state where located.
- Companies with tax residence in Denmark cannot deduct expenses on payments, if such payments directly or indirectly fund deductible expenses subject to hybrid mismatch though (i) a transaction or a number of transactions between associated persons, as defined in §8C(1)(17) of the Danish Corporation Tax Act or (ii) a structured arrangement as defined in §8C(1)(16) of the Danish Corporation Tax Act. However, expenses can be deducted in Denmark where another jurisdiction affected by the arrangement disallows a deduction under a provision regarding hybrid mismatches that is similar to §8D(3) of the Danish Corporation Tax Act.
- Companies with tax residence in both Denmark and a foreign state cannot deduct payments, expenses etc., which are deductible in both states (§8E(1) of the Danish Corporation Tax Act), except to the extent (a) the deductions relate to income that is taxed in both states (§8E(1) of the Danish Corporation Tax Act) or (b) the other jurisdiction is a member of the E.U. and the other jurisdiction refuses to allow deduction for the payment in issue (§8E(2) of the Danish Corporation Tax Act).
- Expenses deducted as part of a double dip structure are not deductible if the income relating to the expenses is not taxable in Denmark (§5G of the Danish Tax Assessment Act). The application of the rules in §5G of the Danish Tax Assessment Act has effectively been expanded by §8E(3) of the Danish Corporation Tax Act. This provision has a “see-through” approach and will be applicable based on whether the group relief in a foreign state facilitates the option to move a tax loss from one company to another within the group in the foreign state. The concept of hybrid mismatches for purposes of the Danish tax regime are defined in §8C(1)(1) of the Danish Corporation Tax Act.

## 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 size 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. when Denmark does not have a double tax treaty in place with the relevant country. Small and medium sized companies include companies which, on a consolidated basis (i) employ less than 250 full time employees during a year and (ii) either reports assets below DKK 125,000,000 (approximately €16,803,108 as of May 31, 2022) or turnover below DKK 250,000,000 (approximately €33,606,216 as of May 31, 2022).

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 results in economic gain.

The Danish tax authorities are authorized to request a special auditor's statement concerning transfer pricing documentation. This occurs where (i) the Danish company reports controlled transactions with controlled parties resident in low-tax countries or (ii) the Danish company's annual reports have shown average operating losses for the previous four years measured at the E.B.I.T. level.

New Danish legislation requires transfer pricing documentation to be submitted annually. The deadline for submitting is 60 days after the due date for the filing of the annual corporate income tax return. Under the new rules, companies subject to transfer pricing documentation requirements are obligated to submit both the local file and the master file.

## 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 as defined in the Danish Financial Statements Act. Consequently, a qualifying group relation exists if a company, foundation, association, trust, or other entity meets any one of the following conditions:

- It is a shareholder of another company and owns the majority of the voting rights in that company.
- It is a shareholder of another company and has the right to appoint or dismiss a majority of the members of the other company's management.

- It is a shareholder of another company and is entitled to exercise control over that company's operational and financial management on the basis of the articles of association or agreement with that other company.
- It is a shareholder of another company and controls a majority of the voting rights in that other company on the basis of a shareholder's agreement.
- It is a shareholder of another company and exercises control over that company's operational and financial management.

The basic principles for determining consolidated income and calculating consolidated income tax have not changed. The administration company and the entities joining in 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. In 2022, carryforward losses of up to DKK 8,872,500 (approximately €1,192,684 as of May 31, 2022) can be used to reduce positive income in the carryover year. The remaining loss can reduce up to 60% of the remaining taxable income in the carryover year. 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 report. 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.

*"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."*

## BINDING ADVANCE RULING

Binding rulings, including advance rulings, on the Danish tax treatment of specific proposed transactions can be obtained from the Danish Tax Authority. A fee of about DKK 400 (approximately €54 as of May 31, 2022) 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 circumstances. The ruling is binding to the extent that (i) the facts presented by the taxpayer upon submission of the request for the ruling do not differ from the actual facts of the transaction, (ii) relevant tax rules remain unchanged and (iii) the ruling is not deemed to be in conflict with applicable E.U. law.

# AUSTRIA

## Author

Dr. Karin Spindler-Simader  
Wolf Theiss  
Vienna

This chapter is based on material prepared originally by Dr. Niklas Schmidt.

## IN GENERAL

Austria does not have a specific regime applicable only to holding companies. Rather, a holding company is taxed in the same way as any other company. Nevertheless, many features of its tax system make Austria a jurisdiction worth considering for international holding companies:

- An international participation exemption exists for dividends received from foreign subsidiaries and capital gains arising from the disposition of their shares.
- A group taxation system exists that also allows cross-border loss relief.
- No formal legislation rules exist regarding thin capitalization.
- Full deductibility is provided for interest expense arising from debt incurred in connection with the acquisition of subsidiaries, subject to certain limitations.
- An extensive network of tax treaties exists, amounting to more than 90 comprehensive treaties in force and effect.
- No withholding tax is due on interest paid to nonresidents.
- No withholding tax is due on capital repayments made to nonresidents.
- The possibility to make use of the E.U. Parent-Subsidiary Directive (“P.S.D.”), the E.U. Merger Directive, and the E.U. Interest and Royalties Directive (“I.R.D.”) exists.
- The possibility of obtaining tax rulings on certain issues exists.

## CAPITALIZATION OF AUSTRIAN COMPANIES

### Equity

No taxes or stamp duties are levied on equity provided to Austrian companies.

### Debt

No taxes or stamp duties are levied on debt provided to Austrian companies.

### Thin Capitalization

Austria does not have a statutory thin capitalization rule. Loan arrangements between an Austrian company and its shareholders or affiliates are generally

recognized for tax purposes, provided that the terms of the loan meet the conditions of an arm's length test so that a third party would grant a similar loan in light of the financial situation of the company. If not, the loan capital would qualify as equity with the result that interest paid on the loan cannot be deducted as a business expense. Instead, interest payments would be treated as hidden distributions to the shareholder, triggering a withholding tax of 27.5%. In practice, debt/equity ratios of 4:1 are not uncommon.

## CORPORATE INCOME TAXATION

### **Resident Companies**

#### **Determination of Residence**

A company is resident in Austria for tax purposes if it has its legal seat and/or its place of management in Austria. The legal seat of a corporation is the place defined as such by law, by contractual agreement, or in its articles of association. The place of management of a corporation is the place where all the measures are taken that are required and essential for the management of the corporation.

#### **Tax Rate and Base**

Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 25% (to be reduced to 24% in 2023 and 23% in 2024). Apart from corporate income tax, no other taxes or surcharges are levied on a corporation's income.

The tax base is generally the profit shown in the financial statements. Adjustments have to be made where mandatory tax provisions deviate from financial accounting rules. Profits are generally taxed on an accrual basis.

Expenses incurred in acquiring, securing, and maintaining taxable income are tax deductible. However, the following types of expenses are partly or fully nondeductible: (i) restaurant expenses, (ii) penalties and fines, (iii) income taxes, (iv) remunerations paid to supervisory board members, (v) remunerations paid to employees and managers exceeding €500,000 per person per year, and (vi) expenses in connection with earning tax-exempt income.

#### **Interest Expense Deduction**

In general, interest – including interest incurred in connection with the acquisition of an Austrian or non-Austrian participation – may be fully deducted from a corporation's tax base. Three restrictions regarding deductibility apply:

- First, financing costs incurred in connection with the acquisition of shares that were directly or indirectly purchased from a group company or from a controlling shareholder are not deductible.
- Second, no deduction is possible for interest paid to a corporation if the payer and recipient are, directly or indirectly, part of the same group, or have, directly or indirectly, the same controlling shareholder, and at the level of the recipient or the beneficial owner, if different, the interest paid is (i) not subject to corporate income tax owing to a comprehensive personal or material tax exemption, (ii) subject to corporate income tax at a rate of less than 10%,

*“An asset subject to wear and tear generally is depreciated on a straight-line basis over its ordinary useful life.”*

(iii) subject to an effective tax rate of less than 10% owing to an applicable reduction, or (iv) subject to a tax rate of less than 10% owing to a tax refund, and here, tax refunds to the shareholder are also relevant. This provision also applies to royalties.

- Third, pursuant to the interest limitation rule, net interest expense in an assessment period is deductible only to the extent of 30% of the E.B.I.T.D.A. Net interest expense is the excess of deductible interest expense over taxable interest income in the assessment period. The E.B.I.T.D.A. equals the preliminary total amount of taxable income, *i.e.*, before applying the interest limitation rule, increased by depreciation and decreased by amortization expenses. Interest means any remuneration for the issuance of debt including all payments made to obtain the debt and any other remuneration that is economically equivalent to interest. Net interest in excess of the deductible amount in the current assessment period can be carried forward to subsequent years. The amount carried forward increases the corporation's interest expenses in the subsequent years, but not its E.B.I.T.D.A. Conversely, if 30% of E.B.I.T.D.A. exceeds the net interest expense in an assessment period (“limitation surplus”), the limitation surplus may be carried forward at the taxpayer's request, but only for the following five years.

The interest limitation rule does not apply in any of the following fact patterns:

- The corporation (i) is not fully included in consolidated financial statements, (ii) does not have an affiliated corporation, and (iii) does not have a foreign permanent establishment.
- The net interest expense of the corporation does not exceed €3 million in the assessment period.
- The corporation (i) is fully included in a group that prepares consolidated financial statements in accordance with Austrian G.A.A.P., I.F.R.S., or another comparable accounting standard and (ii) maintains an equity ratio (shareholder capital divided by assets) as of the reporting date that is either greater than the equity ratio of the group or not more than two percentage points lower than that of the group.
- The interest expense of the corporation relates to debt that is exclusively used to finance long-term public infrastructure projects of general public interest within the E.U.
- The interest expense relates to debt incurred under a binding contract concluded prior to June 17, 2016, but only through assessment periods up to and including 2025.

### Depreciation

An asset subject to wear and tear generally is depreciated on a straight-line basis over its ordinary useful life. If an asset is used for more than six months in the tax year of being placed in service or use, a full year's depreciation deduction may be claimed. Otherwise, only 50% of the yearly depreciation deduction may be claimed in that year.

Depreciation for extraordinary technical or economic loss in value is possible. For certain assets the statute mentions the depreciation rates to be used, namely buildings (generally 2.50% per annum), goodwill (6.67% per annum), and automobiles (12.50% per annum). Assets having an acquisition cost of no more than €800 (to be raised to €1,000 in 2023) can be fully depreciated in the year of purchase.

### Provision of Reserves

Only the following reserve provisions are deductible on a current basis: (i) provisions for severance payments, (ii) provisions for pension payments, (iii) provisions for other contingent liabilities, and (iv) provisions for anticipated losses from pending transactions.

### Net Operating Loss Carryover

Tax losses may be carried forward from past years to reduce the current year's corporate income tax base. The carryforward that may be claimed in any year is limited to 75% of the income of that year. No time limit applies after which the loss cannot be further deducted. In general, carryback of losses is not permitted.

A corporation's tax loss carryforwards are forfeited upon an ownership change if there is additionally a material change in its organizational (e.g., replacement of all directors of the corporation), economic (e.g., a new area of business is pursued by the corporation) and shareholder structure (e.g., the majority of shareholders of the corporation are replaced).

Irrespective of taxable income, a minimum tax is levied. It amounts to €1,750 per annum for limited liability companies and to €3,500 per annum for stock companies (a special minimum tax of €5,452 applies to banks and insurance 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. Minimum tax payments made can be offset against future corporate income tax assessed without any limitations.

### Research and Development

As a special incentive, companies conducting qualified research and development activities may claim a credit (over and above the full deduction of the expense) equal to 14% of eligible expenses.

### Tax Year

The tax year is generally the calendar year. Corporations may apply to the tax authorities for permission to use a different tax year if reasons other than tax considerations exist for the application.

### Tax Filing and Tax Payment

In most cases, corporate income tax returns must be filed electronically by June 30 of the year following the close of the tax year. Taxpayers being represented by tax advisers benefit from longer deadlines. An extension of the filing date is possible in justified cases. Failure to file generally triggers a penalty.

Quarterly prepayments of corporate income tax are due on February 15, May 15, August 15, and November 15. Such prepayments are credited against the final

amount of tax assessed. Any balance is payable within one month after receipt of the tax assessment notice.

## **Nonresident Companies**

### **Definition**

A nonresident company is a company having its legal seat and place of management outside of Austria.

### **Tax Base**

A nonresident company is taxable on business profits to the extent it carries on a business through a permanent establishment or a permanent representative in Austria. Income and capital gains from Austrian real estate are also taxable as business profits of the nonresident company, even if the real estate is not attributable to an Austrian permanent establishment. A nonresident company is further taxable on certain other items of income from Austrian sources, in particular, dividends from Austrian companies or royalties stemming from intellectual property registered in an Austrian register or used in Austria.

## **Participation Exemption**

### **Domestic Participation**

Under the national participation exemption, dividends which an Austrian resident company receives through a direct or indirect participation in an Austrian subsidiary are exempt from Austrian corporate income tax, regardless of the extent of the participation and regardless of the length of time during which the participation in the subsidiary has been held by the parent. This exemption does not apply to capital gains.

### **International Qualified Participation**

Under the international qualified participation exemption, dividends which an Austrian company receives through a direct or indirect participation in a foreign subsidiary that is an E.U. company listed in Article 2 of the P.S.D. or an entity comparable to an Austrian corporation are exempt from Austrian corporate income tax. The parent must hold a participation of at least 10% of the stated share capital of the subsidiary for a minimum duration of one year. The exemption is not applicable if the payment received is deductible abroad.

The international qualified participation exemption applies to capital gains and capital losses realized on the disposal or writing down of shares to a lower fair market value. Hence, capital gains are not taxable and capital losses are not tax deductible in connection with a sale or write-down of shares. However, final capital losses resulting from the liquidation or insolvency of a non-Austrian subsidiary remain tax deductible to the extent they exceed the amount of any tax-exempt dividends received during the last five business years.

As an alternative to tax neutrality, the Austrian parent company may opt for treating all capital gains and capital losses in connection with a sale or write-down of shares as tax effective. In such cases, capital gains are taxable, while capital losses are tax deductible, but the deductible loss is spread over a period of seven years. No





deduction is allowed for capital losses that were directly caused by the prior distribution of profits.

The option for tax effectiveness may be exercised separately for each participation in the corporate income tax return filed for the year in which the participation is acquired. Once the option has been exercised, it cannot be withdrawn.

### **International Portfolio Participation**

Under the international portfolio participation exemption, dividends are exempt from tax when received by an Austrian company through a direct or indirect participation in a foreign subsidiary. The subsidiary must be an E.U. company listed in Article 2 of the P.S.D. or an entity that is comparable to an Austrian corporation. In the latter case, the entity must be resident in a state with which Austria has an agreement for the comprehensive exchange of tax information. The exemption under the international portfolio participation rules applies when the international qualified participation rules are inapplicable. The exemption is not applicable if the payment received is deductible abroad. This exemption does not apply to capital gains.

### **Controlled Foreign Corporation (“C.F.C.”) Rules**

#### **Prerequisites**

Under the Austrian C.F.C. rules, passive income of a foreign low-taxed subsidiary will be included in the tax base of the controlling corporation under certain circumstances.

Passive income encompasses the following types of income:

- Interest or any other income generated by financial assets
- Royalties or any other income generated from intellectual property
- Dividends and income from the disposal of shares, insofar as these would be taxable at the level of the controlling corporation
- Income from financial leasing
- Income from insurance, banking and other financial activities
- Income from invoicing companies that earn sales and services income from goods and services purchased from, and sold to, associated enterprises and that add no or little economic value

A foreign company is low-taxed if its effective foreign tax rate is not more than 12.5%. In order to determine the effective foreign tax rate, the foreign company's income is to be calculated in line with Austrian tax rules and the foreign tax actually paid is divided by the income computed in that manner.

Low taxation is additionally presumed if a foreign company is resident in one of the non-E.U. jurisdictions classifying as noncooperative jurisdictions as of its closing date of the respective financial year (the E.U. list of noncooperative jurisdictions as of February 24, 2022 includes American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, the U.S. Virgin Islands and Vanuatu).

The C.F.C. rules apply if the following facts are present:

- The passive income of the C.F.C. exceeds a third of its total income. For this purpose, the income is to be calculated in line with Austrian tax provisions, except that tax-exempt dividends and capital gains are taken into account when calculating the total income of the foreign corporation.
- The controlling corporation – alone or together with its associated enterprises – holds a direct or indirect participation of more than 50% of the voting rights or owns directly or indirectly more than 50% of the capital or is entitled to receive more than 50% of the profits of the foreign corporation.
- The foreign corporation does not carry out a substantive economic activity supported by staff, equipment, assets and premises. For this purpose, the burden of proof is on the controlling corporation.

The C.F.C. rules are not applicable to foreign financial institutions if not more than one third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

For purposes of the C.F.C. rules, an associated enterprise exists if

- the controlling corporation holds directly or indirectly a participation in terms of voting rights or capital ownership of at least 25% in an entity or is entitled to receive at least 25% of the profits of that entity or
- a legal person or individual or group of persons directly or indirectly holds a participation in terms of voting rights or capital ownership of at least 25% or is entitled to receive at least 25% of the profits of the corporation.

If a legal person or individual or group of persons holds directly or indirectly a participation of at least 25% in the corporation and one or more other entities, all the entities are regarded as associated enterprises.

The C.F.C. rules also apply to Austrian corporations having their place of management outside of Austria and to foreign permanent establishments, even if an applicable double tax treaty provides for a tax exemption in Austria.

### *Consequences of C.F.C. Status*

When the C.F.C. provisions apply to a foreign corporation, the amount of the C.F.C.'s passive income that is included in the tax base of the controlling corporation is calculated in proportion to the direct or indirect participation in the nominal capital of the C.F.C. If the profit entitlement deviates from the participation in the nominal capital, then the profit entitlement ratio is decisive. The passive income of the C.F.C. is included in the financial year of the controlling corporation in which the C.F.C.'s financial year ends. Losses of the controlled foreign company are not included.

In order to prevent double taxation, the following rules apply:

- A C.F.C.'s passive income is not included in the tax base of a controlling corporation that holds only an indirect participation in the C.F.C. where such passive income is already included in the tax base of an Austrian controlling corporation holding a direct participation in the controlled foreign company.



- If the controlling corporation disposes of its participation in the C.F.C., any capital gains are tax exempt insofar as these have previously been included in the controlling corporation's tax base.
- When including the C.F.C.'s passive income in the controlling corporation's tax base, a foreign tax credit is allowed for (i) the corporate income tax imposed on the C.F.C. with regard to its passive income and (ii) the corporate income tax imposed on the C.F.C. in connection with the passive income of a lower-tier subsidiary. Foreign tax credits are allowed upon the making of an application to the Austrian tax authorities.
- If the foreign tax to be credited exceeds the controlling corporation's Austrian corporate income tax, tax credits can upon application also be claimed in the following years.

### **Switch-Over Rule Regarding Participations**

Where applicable, the switch-over rule turns off the exemptions for dividends and capital gains. The switch-over rule applies to two of the categories of participations discussed above in **Participation Exemption**. When the switch-over rule applies, the dividends and capital gains are taxable, and a foreign tax credit is given for the underlying taxes of the foreign subsidiary on dividends.

The switch-over rules apply if the predominant focus of a low-taxed foreign corporation is on earning passive income. The participation categories that are affected are: (i) participations falling under the international qualified participation exemption and (ii) participations of at least 5% falling under the international portfolio participation exemption.

The switch-over rule does not apply if passive income has been taken into account under the C.F.C. provision mentioned above. Also, it is not applicable to foreign financial institutions if not more than one third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

### **Group Taxation**

#### **Prerequisites**

Austrian tax law allows group taxation for affiliated companies. Affiliated companies are those that are connected through direct or indirect participation of more than 50% of the nominal capital and voting rights. This participation must exist throughout the entire fiscal year of the member of the tax group. The conclusion of a profit and loss transfer agreement is not necessary for the purpose of setting up a tax group. Whether the companies in a group earn active or passive income is irrelevant. Thus, pure holding companies are not precluded from participating in a tax group.

The top-tier company in a tax group may be any of the following entities:

- A resident company
- A nonresident company that is an E.U. company listed in Article 2 of the P.S.D. with a permanent establishment in Austria that is registered in the commercial register with the required participations being attributable to such permanent establishment

- A company with its place of management in the E.E.A. that is comparable to an Austrian corporation with a permanent establishment in Austria that is registered in the commercial register with the required participations being attributable to such permanent establishment
- A consortium consisting of two or more companies as specified above, whether structured on a company law basis or on a purely contractual basis, provided that one consortium partner has a participation of at least 40% and each of the other consortium partners has a participation of at least 15%

Members of a tax group may be (i) resident companies and (ii) nonresident companies that are legally comparable to an Austrian corporation. In the latter case, the nonresident company must be resident in another E.U. Member State or a state with which Austria has an agreement for the comprehensive exchange of tax information and exclusively held by resident members of the tax group or the top-tier company of the tax group.

A tax group is not formed automatically. Rather, an application must be submitted to the tax authorities by the group parent. The application must be executed by the management boards of (i) the group parent and (ii) all Austrian group members. The tax authorities then render a binding decision on whether the prerequisites necessary for establishing a tax group have been fulfilled. A tax group must have a minimum duration of three years.

The application for group taxation must contain a declaration stating that an agreement has been concluded between the Austrian-resident affiliated companies regarding the compensation of group members for corporate income taxes paid or not paid as a result of establishing the tax group. It is not necessary to set out the details of the agreement in the application. The application must disclose the respective voting and the participation rights held as well as the financial years of all the companies that wish to participate in the group.

### Consequences

The setting up of a tax group results in 100% of the taxable income of each Austrian-resident member of the group being attributed to the top-tier company in the tax group. The income of each group member is calculated on a company-by-company basis and attributed to the group parent company. Thus, in contrast to a consolidation, income resulting from intra-group transactions is not eliminated for the purpose of calculating group income. The setting up of a tax group in no way affects the profits of the companies involved under financial accounting rules.

The fiscal year for all members of the group need not align. Rather, the fiscal years of all members that end in or with the fiscal year of the group parent are reported by the group parent in the manner described above.

In the case of a tax group formed by a consortium, 100% of the taxable income of each member of the group is attributed to the consortium partners on a *pro rata* basis.

When nonresident companies are members of a tax group, only their losses are attributed on a *pro rata* basis to the top-tier company. Thus, the losses of non-Austrian subsidiaries can be utilized in Austria even though, under general principles, their profits are taxable only in the respective foreign countries. The losses of

***“A tax group is not formed automatically. Rather, an application must be submitted to the tax authorities by the group parent.”***

nonresident group members must be computed in accordance with Austrian tax rules. Nonetheless, these losses cannot exceed the amount calculated pursuant to tax rules in the country of residence of the foreign member.

The aggregate losses of nonresident companies are subject to a ceiling that is similar to the rule for the carryforward of losses. The ceiling is 75% of the income of the top-tier Austrian company in a tax group and the Austrian-resident members.

Losses of nonresident companies that have been deducted by a tax group in Austria are recaptured in Austria to the extent the non-Austrian subsidiary utilizes or may utilize the losses abroad or drops out of the tax group. In the case of final capital losses resulting from a liquidation or insolvency, the recapture is reduced by non-deductible impairments (see below).

Group member tax loss carry forwards resulting from taxable years ending before the tax group was established and tax loss carry forwards assumed by group members pursuant to a restructuring can be applied only against profits generated by the respective group member, up to 100%. On the other hand, tax loss carry forwards of the top-tier company in a tax group can be applied against such company's own profits and also against the profits of group members.

No deductions are allowed for impairments in value of participations in companies that are part of a tax group.

### **Transfer Pricing**

Pursuant to the case law of the Austrian Supreme Administrative Court, agreements between related parties (such as a parent company and its subsidiary) are recognized for tax purposes only under the following conditions:

- The agreements have been concluded in writing.
- Their content is unambiguous.
- They have been concluded in accordance with the arm's-length principle (*i.e.*, on terms that would be agreed by unrelated parties). The Austrian tax authorities follow the O.E.C.D. Transfer Pricing Guidelines in this respect.

Pursuant to the Austrian Transfer Pricing Documentation Act, multinational groups with consolidated group revenues of at least €750 million in the preceding fiscal year are required to prepare a Country-by-Country Report, which Austria will automatically exchange with other countries. Additionally, a separate business unit that is tax-resident in Austria and reports revenues of at least €50 million in the two preceding fiscal years of a multinational group must prepare transfer pricing documentation in the form of a master file and a local file.

## **WITHHOLDING TAX ON OUTBOUND PAYMENTS**

### **Dividends**

#### **P.S.D.**

Dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 27.5%. The rate may be reduced to 25% in case of

corporate shareholders. However, dividends paid by an Austrian company to an E.U.-resident parent company are exempt from taxation under legislation implementing the P.S.D. where the parent company directly or indirectly holds a participation in the Austrian subsidiary of at least 10% for a minimum period of one year. If payments are made before the minimum holding period has elapsed, the payment is subject to withholding taxation. The parent company, however, is entitled to a refund once the minimum holding requirement has been met.

### Potentially Abusive Structure

In addition, tax must be withheld in cases of suspected abuse. In particular, abuse is assumed if the parent company is not engaged in an active trade or business, does not have its own employees, and does not have its own premises. In such cases, withheld tax is refunded on application of the parent company provided that the abuse presumption can be rebutted.

### Treaties

Under most tax treaties, withholding tax is reduced to 15% for portfolio dividends and 5% for qualifying dividends. In some cases, withholding tax may be eliminated entirely. Austria has more than 90 income tax treaties currently in effect, including those contained in the following table:

Albania	Estonia	Luxembourg	Singapore
Algeria	Finland	Macedonia	Slovakia
Argentina	France	Malaysia	Slovenia
Armenia	Georgia	Malta	South Africa
Australia	Germany	Mexico	South Korea
Azerbaijan	Greece	Moldova	Spain
Bahrain	Hong Kong	Mongolia	Sweden
Barbados	Hungary	Montenegro	Switzerland
Belarus	Iceland	Morocco	Taiwan
Belgium	India	Nepal	Tajikistan
Belize	Indonesia	Netherlands	Thailand
Bosnia & Herzegovina	Iran	New Zealand	Tunisia
Brazil	Ireland	Norway	Turkey
Bulgaria	Israel	Pakistan	Turkmenistan
Canada	Italy	Philippines	Ukraine
Chile	Japan	Poland	U.A.E.
China	Kazakhstan	Portugal	U.K.
Croatia	Kosovo	Qatar	U.S.
Cuba	Kuwait	Romania	Uzbekistan
Cyprus	Kyrgyzstan	Russia	Venezuela
Czech Republic	Latvia	San Marino	Vietnam
Denmark	Liechtenstein	Saudi Arabia	
Egypt	Lithuania	Serbia	

### Repayment of Capital

In contrast to dividends from profits, the repayment of capital – whether resulting from a formal capital reduction or from the distribution of capital reserves – does not trigger withholding tax under Austrian domestic law. Such repayment of capital reduces the tax basis of the shares held by the recipient of the dividend. This may become relevant in the case of a later sale of the shares as the capital gain will be increased because of the reduction in basis. Austrian companies must keep a capital account for tax purposes to document the amount distributable as a repayment of capital.

### Capital Gains

A nonresident shareholder is generally subject to taxation on the disposition of shares in an Austrian company if the shareholder has held 1% or more of the share capital at any point in time during the preceding five calendar years. If the participation does not exceed this threshold, capital gains are not taxable. For corporate shareholders, corporate income tax is levied at the regular rate of 25%. The tax is levied by way of assessment rather than by way of withholding.

However, Austria follows the O.E.C.D. Model Convention and generally has ceded its right to tax capital gains from the disposal of shares to the country of residence of the shareholder in most of its tax treaties. Only in case of “real property-rich” companies does Austria retain its right to tax.<sup>1</sup>

### Royalties

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%. Expenses do not reduce the tax base, thereby resulting in gross basis taxation. If the recipient of the royalties is resident in an E.U. or E.E.A. Member State, expenses directly connected to the royalty income may be deducted from the withholding tax base, resulting in net basis taxation. In this case, the withholding tax rate is increased to 25%.

No withholding tax applies within the scope of the I.R.D. Austria exempts intra-group royalty payments from withholding tax if (a) the payor is a resident company or a permanent establishment of a company that is resident in another Member State of the E.U. and (b) the beneficial owner of the royalties is an associated company that is resident in another Member State of the E.U. or a permanent establishment situated in another Member State of the E.U. of an associated company that, itself, is resident in another Member State of the E.U.

For purposes of applying these provisions, a company is an associated company of a second company if any of the following conditions are met:

- The first company has a direct holding of 25% or more in the capital of the second company.
- The second company has a direct holding of 25% or more in the capital of the first company.

<sup>1</sup> O.E.C.D., *Model Tax Convention on Income and on Capital*, paragraph 4 of article 13.



- A third company has a direct holding of 25% or more in the capital of the first and second company.

The I.R.D. treatment is supplemented by the royalty provisions of Austria's income tax treaties. Under most tax treaties, the withholding tax is reduced or eliminated.

### **Interest**

Interest payments on loans (not on bonds) to nonresident corporations are not subject to Austrian withholding tax.

### **Other Income**

A 20% withholding tax is levied on the following types of income earned by nonresidents of Austria:

- Remunerations in connection with an occupation as an author, lecturer, artist, architect, sportsperson, or performer in Austria
- Payments for a right of use regarding works protected by copyrights or industrial property rights
- Supervisory board remunerations
- Payments for commercial or technical consulting work

However, in many of these cases Austria waives its taxing rights under provisions of various tax treaties.

## **OTHER TAX ISSUES**

### **Wealth Tax**

Austria does not currently impose a general wealth tax on companies or individuals. The only wealth tax currently imposed is an annual tax on Austrian real estate levied by Austrian municipalities.

### **Value Added Tax**

Austria levies value added tax in line with the pertinent E.U. Directives at a standard rate of 20%. Reduced rates of 10% and 13% apply to certain supplies. A number of exemptions are applicable. Examples include financial services and health services for which no V.A.T. is imposed.

### **Real Estate Transfer Tax**

The transfer of Austrian real estate triggers real estate transfer tax. In the case of a sale of Austrian real estate the tax base is generally the purchase price, and the tax rate amounts to 3.5%. In addition, a 1.1% court registration fee is assessed, based on the fair market value of the property transferred.

Real estate transfer tax at a rate of 0.5% of the property value of the real estate is triggered if Austrian real estate is part of the assets of a corporation or a partnership, and at least 95% of the shares in the corporation or the interests in the partnership are transferred or pooled in the hand of a single buyer or in the hand of a tax group.



The same applies in the case of a partnership holding Austrian real estate if at least 95% of the interests in the partnership are transferred to new partners within a period of five years.

### **Stamp Duty**

Austria levies stamp duties on a wide range of legal transactions, including assignment agreements, lease agreements, and surety agreements, if a written deed evidencing such stamp-dutiable transaction is signed and a certain Austrian nexus exists. However, these stamp duties can be avoided in many cases by way of careful structuring.

### **Tax Rulings**

A legally binding formal tax ruling procedure exists in connection with questions concerning restructurings, tax groups, international tax law, value added taxation and the existence of abuse of law. If certain formal prerequisites are met, the competent tax office must issue a tax ruling, generally within a period of two months from filing of the application. The ruling must contain the facts and statutory provisions on which it is based, a legal evaluation of the facts, and the time frame during which it is valid. In addition, the applicant may be required to report on whether the facts of the case have been implemented and also on whether the implemented facts are different from those outlined in the request. A fee is due in conjunction with any such request. The fee ranges between €1,500 and €20,000, depending on the applicant's annual turnover,

*“However, these stamp duties can be avoided in many cases by way of careful structuring.”*

### **The General Anti-Avoidance Rule (“G.A.A.R.”)**

Taxpayers are free to arrange their economic affairs in the manner they deem most beneficial, which includes choosing those structures and approaches that incur the least tax cost. Nevertheless, Austrian tax law contains a G.A.A.R. provision that restricts overly aggressive tax planning. Pursuant to this provision, the tax liability cannot be avoided by abusing legal forms and methods available under civil law. If such an abuse has been established, the tax authorities may compute the tax as it would have been had a genuine legal arrangement been carried out.

Abuse is defined as a legal arrangement consisting of one or multiple steps, or a series of legal arrangements, that is not genuine in light of the commercial objective. Arrangements are not genuine when they do not make sense except for the tax-saving effect, because the main purpose or one of the main purposes is to obtain a tax advantage that defeats the object or purpose of the applicable tax law. In principle, no abuse exists if valid commercial reasons exist that reflect economic reality.

### **Notification Obligation Regarding Reportable Cross-Border Arrangements**

Under the Austrian implementation of D.A.C. 6, intermediaries must file information on reportable cross-border arrangements, that is within their knowledge, possession, or control, with the Austrian Minister of Finance generally within 30 days.

Certain arrangements are unconditionally notifiable, while other arrangements are conditionally notifiable where it can be established that the main benefit or one of the main benefits which a person may reasonably expect to derive from the arrangement, having regard to all relevant facts and circumstances, is the obtaining of a tax advantage. In general, the list of hallmarks closely follows D.A.C. 6.

Intermediaries are granted the right to a waiver from filing information on a reportable cross-border arrangement where the reporting obligation would breach the legal professional privilege under Austrian law, unless the intermediary is released from the obligation to secrecy.

### **Hybrid Mismatch Rules**

Austrian corporations are subject to complex hybrid mismatch rules under the Austrian domestic provisions implementing A.T.A.D. 1 and A.T.A.D. 2. These provisions apply in case of the deduction of an expense without inclusion (“D/NI”) or of a double deduction of an expense (“DD”) and for reverse hybrid entities.

- In a D/NI case involving a payment by an Austrian resident, the deduction is denied in Austria if the payment is not taxed abroad. Where the payment is made by a foreign hybrid entity and the deduction is not denied abroad, the earnings are taken into account for tax purposes at the level of the Austrian corporation. In a fact pattern involving a foreign disregarded permanent establishment having income that is neither included in Austria nor in the permanent establishment state, the income is included in Austria.
- In a DD case, the deduction is denied in Austria at the level of the corporation making the payment. Where the deduction involves a payment by an Austrian hybrid entity or an Austrian permanent establishment and the deduction is not denied abroad, the deduction is denied in Austria. In case of a dual resident corporation, the deduction is denied in Austria, unless the corporation is deemed to be solely a resident of Austria under the terms of an income tax treaty concluded with an E.U. Member State. However, deductions may be claimed when the income of the dual resident corporation is subject to tax in the current period or will be in subsequent tax periods.
- Income of a nonresident controlling corporation in a reverse hybrid entity is taxable in Austria if it is not taxed in any other country, regardless of any tax treaty. A reverse hybrid entity is an Austrian partnership that is considered a taxable person under foreign tax law. A nonresident controlling corporation – alone or together with its nonresident associated enterprises – holds, owns, or is entitled to receive, directly or indirectly, a participation of more than 50% of the voting rights, more than 50% of the capital, or more than 50% of the profits of the reverse hybrid entity.

### **Foreign Tax Credit**

Pursuant to a decree issued by the Austrian Ministry of Finance, certain items of foreign-source income are exempt from Austrian taxation, including: (i) income from immovable property located in a foreign state, (ii) business income attributable to a foreign permanent establishment, and (iii) income derived from building sites or construction or installation projects. The decree applies if all the following requirements are met:

- The Austrian taxpayer derives the relevant income from a country with which Austria has not concluded a tax treaty.
- The foreign jurisdiction imposes a tax on the income that is comparable to Austrian income or corporate income taxation.

- The average foreign tax rate computed in accordance with Austrian tax principles exceeds 15%.

The credit method applies to all foreign-source income that is neither exempt from taxation according to the foregoing rule nor subject to a tax treaty. The foreign tax credit is capped at an amount corresponding to the part of the Austrian tax that is attributable to income from sources within the relevant foreign country. No other “basket” rules based on the character of the income exist when computing the allowable foreign tax credit.

Where a tax treaty applies the credit method to foreign-source income, but does not cover local taxes, such local taxes may then be credited against Austrian tax under Austrian domestic law.

Application of the exemption method or the credit method pursuant to the decree requires the taxpayer to maintain proper documentation listing all of the following items:

- The foreign jurisdiction
- The type of income
- The amount of income
- The average foreign tax rate
- The amount of creditable tax where the credit method applies
- The relevant accounting period

## COVID-19 RELATED MEASURES

The Austrian legislator has passed several COVID-19 related measures. The most important changes are discussed below.

### **Depreciation – General Rule**

The acquisition costs of assets are amortized for tax purposes over the normal useful life by way of straight-line depreciation. Taxpayers have the option to use the declining balance depreciation method, applicable to the residual book value at a constant rate of not more than 30% of the declining balance. In this way, the depreciation deduction will be front-loaded.

- It is possible to choose different depreciation methods (*i.e.*, straight-line or declining balance) for different assets.
- Transitioning from the declining balance depreciation method to the straight-line depreciation method is allowed, but only at the beginning of a fiscal year. In this case, straight-line depreciation is to be based on the remaining book value and the remaining useful life of the individual asset at the time of the transition. Transitioning from straight-line to declining balance depreciation is not possible.
- Goodwill, buildings, motor vehicles (certain exceptions apply), intangible assets (certain exceptions apply), used assets and machinery that are used to

extract, transport, or store fossil fuels, as well as machinery that directly uses fossil fuels, are excluded from the option for the declining balance method of depreciation.

### **Depreciation for Buildings**

For buildings acquired after June 30, 2020, taxpayers are entitled to an accelerated form of straight-line depreciation:

- For the first year in which depreciation is claimed, the depreciation deduction is 300% of the straight-line amount and in the second year, the depreciation is 200% of the straight-line amount. The half-year depreciation rule for assets put into operation during the second half of a year does not apply.
- The statutory depreciation rate generally corresponds to (i) 2.5% for buildings held in the context of an active trade or business and (ii) 1.5% for buildings held in the context of an active trade or business, but leased out for residential purposes. Thus, this leads to a maximum depreciation rate of 7.5%.

### **Impairment of Receivables and Provision of Reserves**

For tax years starting after December 31, 2020, receivables may be impaired in a lump sum. Provisions for other contingent liabilities may also be booked in a lump sum.

### **Good Tax Behavior**

Under a law enacted in 2021, Austrian federal subsidies paid out due to the COVID-19 pandemic are now linked to good tax behavior. Companies that fail this character test are excluded from receiving the subsidies mentioned above, and previously obtained subsidies must be repaid with interest.



## FRANCE

### Author

Michel Collet  
CMS-Francis Lefebvre  
Neuilly-sur-Seine

## CORPORATION INCOME TAX – GENERAL

The standard corporation income tax (“C.I.T.”) rate in France for fiscal years beginning in 2022 is 25%. Lower rates apply to small- and medium-sized enterprises (“S.M.E.’s”).

In addition, a 3.3% additional social contribution charge may apply on the portion of the C.I.T. that exceeds €763,000. Stated differently, the additional social contribution generally applies when the taxable profits are greater than €3,052,000. The effective tax rate on the excess is 25.825%.

## NET OPERATING LOSSES

### Carryforward

Net operating losses (“N.O.L.’s”) can be carried forward with no time limit. However, the amount that is offset against the taxable result cannot exceed €1 million plus 50% of the amount of taxable income in the carryforward year that exceeds €1 million. The tax authorities, when auditing the year in which the N.O.L. is claimed as a setoff, may examine the operations that generated the N.O.L. even if the operations took place in fiscal year that is statutory barred.

### 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 2022 can be carried back only to reduce taxable income in 2021. The carryback is capped at €1 million. The carryback does not generate a refund of tax. Rather, it gives rise to a tax credit. This tax credit can be (i) refunded at the end of the five-year period following the year during which the losses were incurred, (ii) used before that date for the payment of the C.I.T. (including the payment of C.I.T. Installments), but not for the payment of the additional contributions to C.I.T.), or (iii) offered as a guaranty to a credit institution.

## TAX CONSOLIDATION

### Scope and Conditions

Under §223A *et seq.* of the F.T.C., a consolidated tax return may be filed by a French company or a French branch of a foreign company that holds, directly or indirectly through other French consolidated companies or, subject to certain conditions,

through an E.U.-resident company,<sup>1</sup> at least 95% of the capital and voting rights of other French companies or branches of foreign companies.

The following conditions must be met in order to file a consolidated tax return:

- All members of the tax-consolidated group are subject to French C.I.T. and have the same financial year.
- Another French company that is subject to C.I.T. does not hold 95% or more of the consolidating company, either directly or indirectly.<sup>2</sup>
- The parent company satisfies the 95% minimum holding, directly or indirectly, throughout the entire financial year.
- Adequate tax group elections have been filed in a timely manner.<sup>3</sup>

The French tax consolidation regime has been modified to reflect a favorable ruling in the *Papillon* case.<sup>4</sup> The European Court of Justice (“E.C.J.”) held that a consolidated group may include French subsidiaries indirectly held through a company or permanent establishment that is (i) resident in the E.U. or E.E.A.<sup>5</sup> and (ii) subject to C.I.T. without exemption in its country of residence.

Pursuant to case law of the E.C.J.,<sup>6</sup> the Amended Finance Law for 2014 allowed the so-called “horizontal tax consolidation” of French sister companies and their subsidiaries under the conditions explained above where at least 95% of their shares are held, directly or indirectly, by the same company that is resident in the E.U. or the E.E.A. This foreign entity must be subject to C.I.T. in its country of residence and must have the same financial year-end. Where these facts exist, one of the two top sister companies may elect to be the consolidating company.

### **Computation of the Group Taxable Result**

The consolidating company is liable for C.I.T. on the group taxable income, which is the sum of all members’ profits and losses, including capital gains and losses. This aggregated taxable result is subject to the following adjustments:

- Provisions for doubtful accounts and risks on other members of the consolidation are reinstated for tax purposes. Later reversal of provisions would be eliminated for tax purposes.
- Provisions for depreciation of assets acquired from other members of the consolidation are reinstated for tax purposes, up to the net capital gain that

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<sup>1</sup> Or companies situated in Norway, Iceland, or Liechtenstein.

<sup>2</sup> A French company subject to C.I.T. may indirectly hold a 95% participation in the consolidating company, provided it is held through a company not subject to C.I.T. or through companies in which it maintains an interest of less than 95%.

<sup>3</sup> The filing deadline matches the deadline for filing C.I.T. annual returns.

<sup>4</sup> *Société Papillon v. Ministère du Budget, des Comptes Publics et de la Fonction Publique*, Case C-418/07, [2008] E.C.R. I-08947.

<sup>5</sup> Liechtenstein, Norway, Iceland.

<sup>6</sup> *SCA Group Holding and Others*, Joined Cases C-39-41/13, [2014] ECLI:EU:C:2014:1758.

was eliminated for the computation of the group taxable income (see below). Future reversal of the provision would be tax neutral.

- Capital gains and losses on the transfer of fixed assets and shares between members of the consolidation are eliminated. They would be recaptured in case of transfer of the assets out of the consolidation, exit of the owner or the seller from the consolidation, termination of the consolidation, or contribution of the assets to a member of the consolidation.
- Conversely, the deductibility of the amortizations in the hands of the acquirer is limited to the difference between (i) the yearly depreciation calculated by the acquirer with respect to the acquisition cost in its books and (ii) the yearly depreciation calculated by the seller on the acquisition cost registered in its own books.
- Sales of goods or services occurring between group companies at a price below their fair market value but above their tax cost do not entail any adverse tax consequences.
- Distributions made between companies of the tax group are tax exempt up to 99% of their amount. This exemption also applies to dividends received from subsidiaries in the E.U. or E.E.A. that would have been qualified to file a consolidated return had they been located in France for tax purposes.

Several decisions of the E.C.J. have targeted the French tax consolidation regime as going beyond the mere consolidation of results. Consequently, the Finance Act for 2019 has repealed the tax elimination of income arising from several transactions occurring within the tax consolidation with effect from January 1, 2019:

- With the exception of sales of goods or services within the consolidation invoiced at cost, debt waivers and subsidies granted between members of the tax group are no longer eliminated.
- Subsidies granted before January 1, 2019 and eliminated under the former regime may become taxable at the termination of the tax group or the exit of a member involved in the transaction. This treatment applies to indirect subsidies on the transfer of fixed assets and shares through reduction of the sale price that were eliminated, and other indirect subsidies, direct subsidies, and debt waivers granted during one of the five fiscal years preceding the exit or the termination.
- The transfer of substantial shareholdings (see C.G.T. on company shareholdings) eligible for the 88% tax relief are no longer fully eliminated if they are realized after January 1, 2019. Accordingly, capital gains on substantial shareholdings are taxable at group level on 12% of the gain. The 12% taxable portion on transfer realized before 1 January 2019 and eliminated pursuant to former rules are taxable at (i) the first transfer of the shares after January 1, 2019 or (ii) at the time the owner entity exits the tax group after that date.

The above provisions may also, under certain circumstances, apply to transactions with E.U. intermediary entities (for example, an E.U. entity interposed between two French entities that are members of the consolidation) or E.U. consolidating entities (in case of so-called horizontal consolidations).



## **Specific Group Provisions**

An anti-debt-push-down provision under §223B, known as the “*Charasse Amendment*,” restricts the deduction of interest expense where a member of a tax-consolidated group purchases from its controlling shareholders shares of a company that subsequently becomes part of the same tax-consolidated group. In such a case, the acquiring company must reduce interest expense incurred to fund the acquisition for the year of the acquisition and the following eight years.<sup>7</sup>

The limitation of deductibility of net financial charges (see the discussion in **Deductibility of Interest Charges**, below) and the Intellectual Property box regime (see the discussion in **Taxation of Inbound Royalties - New Industrial Property (“I.P.”) Box Regime**, below) apply at group level when group taxation has been elected.

Several provisions also aim at facilitating restructurings within the consolidation:

- Mergers between companies of the tax group can be carried out free of tax if the conditions of a reorganization regime are met.
- The acquisition or merger of the consolidating entity by a French entity that fulfills all the conditions to be the consolidating entity, itself, will not cause the tax group treatment from being terminated. Some de-grouping charges may be suffered, but several dispositions intend to mitigate these adverse tax consequences.

Tax grouping is attractive in a leveraged buyout because it combines consolidation and tax-free distributions, albeit subject to the 1% add-back.

## **TAXATION OF TAX TRANSPARENT ENTITIES**

French partnerships in the form of an S.N.C., an S.C., or an S.C.S. are tax transparent entities under French tax law. Also, tax transparent are limited partnerships of an S.C.A., but only for the shareholders having unlimited liability. Some limited liability companies such as an S.A.R.L. held by families can elect for tax transparent treatment.

Members with limited liability in a partnership are not entitled to transparent tax treatment. Consequently, profits or losses are not deemed to be realized by the partners, but by the entity even though the partnership is not subject to tax. In such case, the partners are responsible for the tax on the partnership’s income on a *pro rata* basis in the capital.

In the context of foreign partnership, the legal characteristics of the foreign entity are analyzed and compared with those of a French entity. The focus is directed mostly to liability and incorporation resulting in legal personality. The analysis is used to identify the French fiscal regime applicable to the entity.<sup>8</sup> Limited partnerships are most often compared to corporations.

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<sup>7</sup> Interest expense disallowed under the Charasse Amendment are determined using the following formula: (interest expense of all tax group members) × (acquisition price ÷ average indebtedness of all tax group members).

<sup>8</sup> *Conseil d’Etat*, November 24, 2014, #363556, *Artemis*.



As an exception to the principle of translucent entities – meaning entities that qualify for treaty benefits because their shareholders qualify for those benefits – administrative guidelines state that passive income paid by French entities to foreign partnerships that are tax transparent in their own jurisdictions are deemed paid to the members of the partnership for application of French domestic law and double tax treaties.<sup>9</sup>

France has concluded several tax treaties that specifically address tax transparent entities, such as treaties with the U.S., the U.K., Switzerland, Japan, Luxembourg, and Germany.

## FOREIGN TAX CREDITS

In absence of double tax treaties, double tax relief takes the form of a deduction from income that may be claimed for a foreign tax on income that is taxable in France. Consequently, no tax credit is allowed unless a tax treaty applies.<sup>10</sup>

In presence of a double tax treaty, foreign taxes generally give rise to a foreign tax credit available against French tax on the same income. Most of the treaties provide that the foreign tax credit is limited to the tax due in France on this income, although exceptions exist, mostly in connection with African countries. The foreign tax credit in excess of the French tax or the foreign tax credit claimed by a loss-making entity is not creditable and not deductible. Foreign taxes levied in contradiction to the terms of an income tax treaty are deductible, only. Thus, the benefit comes in the form of a reduction in French taxable income, not a setoff against French income tax.

## TAXATION OF DIVIDENDS

Dividends are included within the taxable result of corporations. However, a participation-exemption regime applies to limit the tax burden on distributions.

### **Taxation of Inbound Distribution – The Dividends Received Deduction (“D.R.D.”)**

Dividend distributions received by French corporations are subject to C.I.T., in principle. The tax residence of the company paying the dividend is not material. Under the new D.R.D. regime, distributions are 95% exempt from C.I.T. where all the following conditions are met:

- The shares are in registered form or deposited with an accredited institution.
- The receiving corporation holds at least 5% of the capital of the distributing company (“Qualifying Shareholding”) and is the beneficial owner of the dividends.<sup>11</sup>
- The Qualifying Shareholding must be held for at least two years.

<sup>9</sup> BOI-INT-DG-20-20-30 n°120 à 140

<sup>10</sup> Article 39,1, 4° of the French Tax Code (“F.T.C.”).

<sup>11</sup> In accordance with recent French case law, Article 145 1-b of the F.T.C. has been amended to include both full ownership and bare ownership as qualifying for the 5% capital threshold.

*“In absence of double tax treaties, double tax relief takes the form of a deduction from income that may be claimed for a foreign tax on income that is taxable in France.”*

Pursuant to several decisions of the Constitutional Court, dividends on preference shares with reduced voting rights or none at all are eligible for the exemption.<sup>12</sup>

The exemption applies from the first day of the Qualifying Shareholding, provided that the shares are held for two years. Failure to maintain the shares for two years will result in a claw-back of the exemption. A disposal of shares within the course of a tax-free reorganization is disregarded for D.R.D. purposes.

The D.R.D. regime applies to dividends and other distributions attached to the shares of stock held by the receiving corporation.

The 95% exemption under the D.R.D. is achieved by exempting the entire dividend received, but disallowing deductions for otherwise deductible expenses in an amount equal to 5% of the D.R.D. claimed. The disallowed amount is deemed to be costs for management of the shareholding. N.O.L.'s can be offset against that taxable amount.

The D.R.D. applies to dividends received from foreign subsidiaries without limitation, other than those conditions set forth above. Subject to the application of tax treaties, foreign tax withheld in a source country may be used 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.<sup>13</sup> The ability to credit the withholding taxes incurred on the inbound dividend against the French withholding tax on the outbound dividend lapses after five fiscal years. Otherwise, tax withheld at the source on the inbound dividend is not recoverable by the French shareholder.<sup>14</sup> The 5% add-back to the D.R.D. is calculated on the gross amount of the dividends received from the foreign subsidiary.

Distributions from a company established in a Non-Cooperative State or Territory ("N.C.S.T.") are not eligible for the D.R.D., except where the corporate shareholder justifies that its holding reflects a valid commercial purpose and is not driven by tax fraud. The N.C.S.T. legislation is discussed in detail below in **Other Specific Anti-Abuse Provisions**.

In anticipation of efforts to combat base erosion and hybrid instruments, the D.R.D. is not applicable to distributions that give rise to deduction at the level of the payor company. This provision complies with the amendment of the P.S.D. on cross-border distributions within the E.U. single market. Under the amendment, the P.S.D. does not apply when a deduction is claimed by the payor company for the dividend paid.<sup>15</sup>

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<sup>12</sup> Cons. Const., February 3, 2016, no. 2015-520, QPC; Cons. Const., July 8, 2016, no. 2016-553 QPC.

<sup>13</sup> French Administrative Guidelines, BOI-RPPM-RCM-30-30-20-50, September 12, 2012.

<sup>14</sup> However, a recent non-definitive decision of the appeal court ruled that tax withheld at the source on the inbound dividend might be used as a tax credit against French C.I.T. due on the 5%-dividends remaining from the D.R.D. application. The decision is likely to be confirmed by the *Conseil d'Etat*.

<sup>15</sup> Council Directive 2014/86/E.U. amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the case of Parent Companies and Subsidiaries of Different Member States, 2014 O.J. L 219/40.

*“In practice, the presence of an autonomous decision-making process at the level of the holding company is generally critical in asserting the validity of its commercial purpose.”*

Since January 1, 2019, dividends distributed by subsidiaries located in a Member State of the E.U. or the E.E.A. to a French company and eligible to the D.R.D. with a 99% exemption if (i) the French company is not in position to opt for a French tax consolidation (see above discussion of tax consolidations at **Scope and Conditions**) and (ii) the company making the distribution meets all the conditions required in order to participate in the filing of a consolidated tax return in France, were they to be established in France.

The exemption is subject to the general anti-abuse rule of Article 6 of E.U. Directive 2016/1164/E.U. (“G.A.A.R.”). See Article 205 A of the F.T.C. – General C.I.T. Anti-Abuse Provision.

The G.A.A.R. tackles an arrangement or a series of arrangements that (i) have been put into place for the main purpose, or one of the main purposes, of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and (ii) are not genuine, having regard to all relevant facts and circumstances. An arrangement or a series thereof is regarded as non-genuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality.

The guidelines of the French tax authorities consider that the condition of “commercial purpose” does not necessarily exclude structures set-up for fundholding, financial or organizational purposes.

In practice, the presence of an autonomous decision-making process at the level of the holding company is generally critical in asserting the validity of its commercial purpose. Stated differently, prudence suggests that the commercial reasons for a structure should be provided by operating management and not the tax department.

Finally, a transfer of qualifying stock to a *fiducie*, which is the equivalent of a trust under French law, is not treated as a disposal for D.R.D. purposes despite the transfer of legal ownership. Through the trustee (*fiduciaire*), the settlor (*constituant*) must maintain by contract all its voting and financial rights on the stock. This development allows the use of a *fiducie* for leveraged buyouts (“L.B.O.’s”) or debt restructuring and proves more flexible and less burdensome than the so-called “double Luxco structure,” which is not exempt from tax or legal challenges.<sup>16</sup>

### **Withholding Tax on Outbound Dividends**

Under §119-*bis* 2 of the F.T.C., a 30% withholding tax is levied on outbound dividend payments. The withholding tax has been reduced to the standard rate of C.I.T. from January 1, 2020. Dividend payments made to entities based in an N.C.S.T., other than those on the grey list, are subject to a withholding tax of 75%. An exception is provided where the French entity making the distribution can demonstrate that the distribution is not mainly tax driven.

In comparison, withholding is not required on dividends paid to qualifying E.U. parent companies (i) subject to a 10% ownership test (the “E.U. Directive Exemption”) or (ii) subject to a 5% ownership test (the “5% E.U. Exemption”) where the E.U. parent company is unable to recover French-source withholding tax in its residence jurisdiction. In both cases, a two-year holding requirement applies.

<sup>16</sup>

Amending Finance Law for 2014, no. 2014-1655 of December 29, 2014.

Under certain conditions, withholding tax is not due when distributions are paid to collective investment funds established in the E.U. or in a country with which France has signed a convention on administrative assistance, which is the case with a large number of countries.

## TAX TREATMENT TO OUTBOUND DIVIDENDS PAID TO COMPANIES LOCATED IN THE E.U.

### E.U. Directive Exemption

The E.U. Directive Exemption applies if the following tests are met:

- The distributing company is subject to C.I.T. at the standard rate in France without exemption.
- The shareholder corporation is an E.U. or E.E.A. resident, defined as having its place of management and control in another E.U. or E.E.A. Member State.
- The shareholder corporation is incorporated under one of the legal forms listed as an appendix to the E.U. Directive 2011/96/E.U. dated November 30, 2011.
- The shareholder corporation is the beneficial owner of the dividends distributed.
- The shareholder corporation is subject to C.I.T. in its E.U. or E.E.A. Member State of establishment, without option or exemption.
- The shareholder corporation holds directly 10% or more of the capital of the distributing company.<sup>17</sup>

The dividend may be paid to an E.U. or E.E.A. permanent establishment of an eligible shareholder corporation.

To comply with the provisions of the P.S.D., the exemption has been amended to reflect the E.U.-inspired anti-abuse provision already introduced for the French D.R.D. Thus, for fiscal years beginning on or after January 1, 2016, the E.U. Directive Exemption no longer applies to dividends received if the corporate shareholder cannot provide justification that the ownership structure was chosen for a “valid” commercial purpose and not with the primary aim of obtaining the exemption.

This anti-abuse provision is not modified by the introduction of a new Principal Purpose Test (“P.P.T.”) under the domestic G.A.A.R. provisions applicable to C.I.T., which does not cover withholding taxes. This is discussed below at **General Anti-Avoidance Provisions**.

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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.

### **5% E.U. Exemption**

French sourced dividends paid to a qualifying shareholder that is not taxable in its jurisdiction of residence are exempt from withholding tax, under the following conditions:

- The shareholder benefits from an exemption regime in its country of residence. This is to say that the recipient shareholder is not able to credit the French withholding tax against its tax in the country of residence.
- The shareholder is a resident of the E.U. or of Liechtenstein, Norway, or Iceland,<sup>18</sup> provided that the recipient shareholder's country of residence has entered into a qualifying tax treaty with France.
- The parties have not entered into an artificial arrangement for tax avoidance.
- The shares of stock owned (i) constitutes 5% of the capital and voting rights of the distributing company, (ii) is in registered form or is kept by a financial establishment, and (iii) is held for at least two years.

When the above requirements are met, the French withholding tax exemption automatically applies pursuant to the *Denkavit* case.<sup>19</sup> If the dividend is taxed in the jurisdiction of residence of the E.U. shareholder, the dividend may be paid gross if the E.U. qualifying corporate shareholder owns 10% or more of the French company making the distribution.

One may rely on tax treaty provisions as an alternative to the 5% E.U. Exemption. Several tax treaties provide for zero withholding tax on dividends, including those with Spain, Germany, Japan, and the U.S.

### **Outbound Dividends and Tax Treaties**

Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, ranging generally from 25% to 5%. In addition, some tax treaties provide for zero withholding tax on dividends, as mentioned in the immediately preceding paragraph. Some income tax treaties have a narrow definition of dividends that restricts the application of the dividend provision to distributions that qualify as a dividend under corporate law.<sup>20</sup> Consequently, distributions that are treated as dividends under tax law rather than corporate law may not be covered by the dividend provision. Instead, they may fall under the other income provision of the treaty, leading to a withholding tax exemption in France. An example of a dividend for tax purposes that is not a dividend for corporate law purposes is an exceptional distribution of reserves.

<sup>18</sup> As members of the E.E.A.

<sup>19</sup> *Denkavit Internationaal BV and Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, Case C-170/05, [2006] ECLI:EU:C:2006:783.

<sup>20</sup> CE October 13, 1999, *SA Banque Francaise de l'Orient*, RJF 12/99 no. 1587.



As of the last day of May 2022, France has 125 tax treaties currently in force, as follows:

Albania	Estonia	Macedonia	Serbia
Algeria	Ethiopia	Madagascar	Singapore
Andorra	Finland	Malawi	Slovakia
Argentina	French Polynesia	Malaysia	Slovenia
Armenia	Gabon	Mali	South Africa
Australia	Georgia	Malta	South Korea
Austria	Germany	Mauritania	Spain
Azerbaijan	Greece	Mauritius	Sri Lanka
Bahrain	Ghana	Mexico	St. Martin
Bangladesh	Guinea	Monaco	St. Pierre & Miquelon
Belarus	Hong Kong	Mongolia	Sweden
Belgium	Hungary	Montenegro	Switzerland
Benin	Iceland	Morocco	Syria
Bolivia	India	Namibia	Taiwan
Bosnia & Herzegovina	Indonesia	Netherlands	Thailand
Botswana	Iran	New Caledonia	Togo
Brazil	Ireland	New Zealand	Trinidad & Tobago
Bulgaria	Israel	Niger	Tunisia
Burkina Faso	Italy	Nigeria	Turkey
Cameroon	Ivory Coast	Norway	Turkmenistan
Canada	Jamaica	Oman	Ukraine
C.A.R.	Japan	Pakistan	U.A.E.
Chile	Jordan	Panama	U.K.
China	Kazakhstan	Philippines	U.S.A.
Colombia	Kenya	Poland	Uzbekistan
Congo (Rep.)	Kosovo	Portugal	Venezuela
Croatia	Kuwait	Qatar	Vietnam
Cyprus	Latvia	Québec	Zambia
Czech Republic	Lebanon	Romania	Zimbabwe
Denmark	Libya	Russia	
Ecuador	Lithuania	Saudi Arabia	

France signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on July 6, 2017 (which entered into force on January 1, 2019). The French position covers 120 of the French double tax treaties and includes several reservations.

### **Branch Tax**<sup>21</sup>

Profits realized by foreign companies from activities conducted in France through a permanent establishment are deemed to be distributed and subject to a 25% withholding tax. As with actual dividends, the rate is reduced to the standard rate of CIT as from January 1, 2020, except for foreign companies located in an N.C.S.T

<sup>21</sup> Article 115 quinquies of the F.T.C.

jurisdiction. There, the profits derived from a French permanent establishment are subject to a 75% withholding tax.

This branch tax does not apply to permanent establishment held by E.U. or E.E.A. companies, and most of the double tax treaties provide for an exemption. If applicable, the withholding tax may be adjusted in view of ex-post distributions or results.

## TAXATION OF INTEREST

### **Deductibility of Interest Charges**

Interest paid on a debt-financed acquisition of shares is deductible, even if the shareholder qualifies for the D.R.D., as discussed above at **Taxation of Inbound Distribution – The Dividends Received Deduction** and below at **C.G.T. on Real Estate Holding Companies**. The deduction may be limited by several provisions.

Also, a specific anti-debt push-down mechanism restricts the deductibility of interest within tax consolidated groups. See the discussion under the *Charasse Amendment* below in **Deductibility of Interest Charges**.

### **Interest Rate Test**

Interest expense arising from intercompany debt is tax deductible only within the limit of a rate corresponding to the average annual interest rate granted by credit institutions to companies for medium-term loans, *i.e.*, 1.15% for Q1 2022.

Interest expense exceeding this limit are deductible only to the extent that the company establishes that they are arm's length. The arm's length rate is determined by comparison to market practices in regard to the characteristics of the loan and the debtor, without consideration of the economic position of the group. A recent decision allows the use rates quoted in the bonds market to serve as a comparable.<sup>22</sup>

Intercompany interest payments that exceed the arm's length rate are treated as a distribution eligible for benefits under the D.R.D. or the terms of an applicable income tax treaty. Some tax treaties do not address deemed distributions and therefore deny France the right to tax a deemed distribution. An example is the treaty with the Netherlands.

### **Charasse Amendment (Tax Consolidations)**

An anti-debt-push-down provision under §223B, known as the "*Charasse Amendment*," restricts the deduction of interest expense where a member of a tax consolidated group purchases from its controlling shareholders shares of a company that subsequently becomes part of the same tax-consolidated group. Where that occurs, the acquiring company must reduce the deduction for interest expense incurred to fund the acquisition for the year of the acquisition and the following eight years.<sup>23</sup>

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<sup>22</sup> Supreme Tax Court 8e-3e ch. 10-7-2019, #429426, *SAS Wheelabrator Group*.

<sup>23</sup> Interest expense disallowed under the *Charasse Amendment* are determined using the following formula: (interest expense of all tax group members) × (acquisition price ÷ average indebtedness of all tax group members).

### The General Interest Limitation Regime

Interest expense that is deductible after applying the foregoing tests are subject to the new set of deduction limitation rules. These rules are applicable under French tax law as from January 1, 2019, and are derived from the E.U. Anti-Tax Avoidance Directive (“A.T.A.D.”). See **General Anti-Avoidance Provisions** and **Other Specific Anti-Abuse Provisions**, below, for additional discussion on the A.T.A.D.

Former French thin capitalization and interest barrier rules (*i.e.*, the “*robot*”) have been repealed and replaced by a new general limitation mechanism, pursuant to which deductible net financial expenses of a company (absent any tax group) are capped to the higher of (i) 30% of the company’s adjusted tax E.B.I.T.D.A. or (ii) €3 million. Net financial expenses that become nondeductible may be carried forward with no time limit. Unused deduction capacity may also be carried forward for five years.

Additionally, where the equity-to-assets ratio of the company is equal or greater than the equity-to-assets ratio of the consolidated accounting group to which the company belongs, 75% of the net financial expenses exceeding the 30% or €3 million thresholds may still be deducted. This 75% allowance also applies to stand-alone entities that do not belong to an accounting consolidation, that do not maintain establishments abroad no related entities.

The company’s ratio is deemed to be equal to the accounting group’s ratio if the difference between these two ratios does not exceed 2%. French law provides that this safe harbor will be applicable to companies consolidated in a global integration, under I.F.R.S. or French consolidation principles. Companies consolidated under U.S. G.A.A.P. currently fall outside the scope of this safe harbor although we may expect the French tax authorities to extend the scope of the safe harbor to U.S. G.A.A.P. when commenting on the new provisions, as they did for the repealed Carrez rules and the thin capitalization rules.

As an exception, special rules may apply if the company is thinly capitalized, *i.e.*, if its debt-to-equity ratio exceeds 1.5:1 computed only by reference to intragroup debt, thereby excluding all third-party debt, even if such debt is guaranteed by a related party. The deduction thresholds are reduced to €1 million or 10% of the adjusted taxable profits related to the interest expense on excessive indebtedness, unless this ratio is not higher than the debt-to-equity ratio of the accounting consolidation group to which the company belongs. In these circumstances, only 1/3rd of the nondeductible amount may be carried forward. Additionally, thinly capitalized companies may not carry forward their unused deduction capacity.

Disallowed interest expense under these limitations are not considered for the purpose of the calculation of the portion of nondeductible financial expenses under the general limitation.

Similar regimes apply to both individual entities (§212-*bis* of the F.T.C.) and French tax consolidated groups (§223 B-*bis* of the F.T.C.).

### M&A Context Limitation

The Finance Act for 2019 repealed the former limitation aimed at interest charges incurred by French investment vehicles that acquire substantial shareholdings in a French subsidiary. This provision limited the deduction of interest charges unless



the acquiring company evidenced its involvement within the management and strategy of the target company.

### **Withholding Tax on Interest – Exemptions**

According to §§119-*bis* 1 and 125 A III of the F.T.C., a withholding tax is imposed on interest paid to a nonresident recipient. However, French domestic tax law provides for several exemptions, resulting in the almost systematic exemption from withholding tax. Three of these exemptions are outlined below for (a) interest on loans, (b) interest on bonds, and (c) interest paid inside the E.U. On the other hand, interest paid to N.C.S.T.'s are subject to 75% withholding tax in France, unless an income tax treaty provides for a lower rate.

Moving beyond domestic law, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company. For example, French income tax treaties with Germany, Austria, the U.K., Ireland, and Sweden provide for zero withholding tax on interest.

#### **Interest on Loans**

For loans contracted on or after March 1, 2010, no withholding tax applies to interest paid by a French company to a nonresident company. This exemption does not apply to interest paid to an N.C.S.T. Instead, a 75% withholding tax is applicable where (i) the interest is paid to a resident of an N.C.S.T. jurisdiction that is not on the grey list or (ii) the French borrower justifies that the transaction generating the interest payment was not principally aimed at, or resulted in, the shift of profits to the N.C.S.T. jurisdiction.

For loans contracted before March 1, 2010, interest can be paid free of withholding tax in several circumstances:

- The initial lender is a nonresident individual or legal entity that is established outside of France.
- The loan is documented by an agreement executed before the loan proceeds are transferred to the French company.
- The loan agreement sets forth the principal, the date of repayment, the interest rate, and any additional remuneration to the lender.

The subsequent sale or assignment of the receivable should not jeopardize the application of the exemption.

#### **Interest on Bonds**

Under §119-*bis* 1 of the F.T.C., interest paid to nonresidents on bonds from French issuers is exempt from withholding tax provided that the securities were issued after January 1, 1987.

Under §125 A III of the F.T.C., the levy at source is not applicable to interest on bonds issued after October 1, 1984 that are paid by a debtor domiciled or established in France, if the beneficial owner of the interest demonstrates that he or she has a fiscal domicile or corporate seat outside the territory of the French Republic, Monaco, or a member state of the so-called “*Zone Franc.*” Evidence of the foreign domicile or seat of the beneficial owner must be furnished to the paying agent of



the interest. Evidence of the foreign domicile is assumed for bonds converted into euros on or after January 1, 1999. The exemption applies to tradable securities and units in French securitization vehicles (*fonds commun de créances*).

### *Interest Paid to a Related E.U. Company*

Interest is exempt when the recipient is an eligible E.U. company that is subject to C.I.T. in its jurisdiction of residence and the payer and the beneficial owner are related parties. Parties will be treated as related where (i) the payer directly owns at least 25% of the capital of the beneficial owner of the payment, (ii) the beneficial owner of the payment owns at least 25% of the payor, or (iii) a third E.U. company directly holds at least 25% of the capital of both the payer and the beneficial owner of the payment. The ownership interest must be held for at least two years. Payments made before the expiration of the two-year period can be exempted from withholding tax if the shareholder undertakes to hold the ownership interest for at least two years. An E.U. permanent establishment of an eligible E.U. company can be treated as an eligible payer or beneficial owner of the payment as long as the interest is subject to C.I.T. in the E.U. Member State in which the permanent establishment is located. The beneficial owner of the payments must give the payer all required evidence that the tests have been fulfilled.

An anti-abuse provision denies the exemption where the beneficial owner is controlled directly or indirectly by a non-E.U. corporate shareholder and obtaining the tax benefit is a principal reason for the structure. However, this provision is of little interest when the double tax treaty applicable between France and the jurisdiction of the controlling shareholder provides for an exemption of withholding tax. The U.S. is one such example.

## **TAXATION OF REMUNERATION OF SERVICES AND ROYALTIES ON I.P.**

### **Taxation of Outbound Payments**

The payment of fees to foreign companies that do not have a permanent establishment in France are subject to a withholding tax equal to the standard rate of C.I.T.<sup>24</sup> when the payment relates to (a) services provided or used in France or (b) royalties for the use of intangible property in France. This rate is increased to 75% for payments made to companies established in an N.C.S.T. jurisdiction.

The criteria of services used or provided in France may be interpreted quite broadly. For example, the Supreme Tax Court has ruled that services paid to a Hong-Kong company who performed scouting services (identification of furnishers) for a French company were used in France to make business decisions.<sup>25</sup>

Payments made between related E.U./E.E.A. companies are exempted from withholding taxes under the same conditions as the interest payments. In addition, withholding taxes on payments to loss-making E.U./E.E.A. companies may be refunded.

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<sup>24</sup> Article 182 B of the F.T.C.

<sup>25</sup> Supreme Tax Court, 9e-10e ch. October 22, 2018 #406576, *Sté Sud Trading Company*.

## **Taxation of Inbound Payments for Services**

Remuneration of services are taxable under normal C.I.T. rules.

## **Taxation of Inbound Royalties - New Industrial Property (“I.P.”) Box Regime**

Further to the O.E.C.D. B.E.P.S. Action 5 Report, France has amended its I.P. box regime.

The former French I.P. box regime consisted in a distinct taxation of I.P. income at a reduced rate of 15%. The benefit of the reduced rate was not connected to the location of research and development (“R&D”) expenditures in France. Therefore, the O.E.C.D. considered that this regime was not in line with the nexus approach.

As a result, France adopted the nexus approach which is intended to condition the I.P. box regime in a given jurisdiction to R&D activity resulting in expenditures in the same jurisdiction. The eligible net R&D income after deduction of R&D expenditures is taxed at the rate of 10%.

The new regime was introduced by the Finance Act for 2019 and is codified in §238 of the F.T.C. This regime is optional and applies to tax years beginning on or after January 1, 2019. Election is made for each asset, good or service, or family of goods or services in the tax return for the financial year in respect of which it is exercised. The election must be renewed each financial year. If not, the benefit is terminated. It applies to standalone entities and French tax consolidated groups.

## **Eligible Intangible Assets**

The new regime applies to transactions involving I.P. including

- patents,
- utility certificates and supplementary protection certificates attached to a patent,
- software protected by copyright,
- industrial manufacturing process resulting from research operations, and
- non-patented assets whose patentability has been certified by the National Institute of Industrial Property (“N.I.I.P.”), provided they have the character of fixed intangible assets.

## **Application of the Nexus Approach**

According to §238 of the F.T.C., the qualifying I.P. income must be determined in three stages.

### **Stage 1: Determination of the Net Profit**

The net profit that is entitled to the reduced tax rate is the gross incomes derived from the licensing, sublicensing, or transfer of an intangible asset for the financial year minus R&D expenditures directly linked to this asset, incurred directly or indirectly by the taxpayer during the same period.

*“Qualifying expenditures are R&D expenditures directly related to the creation and development of the intangible asset carried out directly by the taxpayer or outsourced to unrelated entities.”*

### Stage 2: Determination of the Nexus Ratio

The nexus ratio is used to determine the portion of the net profit determined in Step 1 that is attributable to the taxpayer. To compute the ratio, the qualifying expenditure directly related to income derived from the I.P. rights and directly incurred by the taxpayer or by unrelated companies engaged by the taxpayer is divided by the sum of (i) the foregoing expenditures, (ii) comparable expenditures incurred by related parties, and (iii) the cost of acquiring I.P. assets such as the purchase of a patent. In broad terms the nexus ratio measures (a) the contribution of the taxpayer to the R&D activity in relation to (b) all contributions of related parties plus the cost of acquiring I.P. assets.

Qualifying expenditures are R&D expenditures directly related to the creation and development of the intangible asset carried out directly by the taxpayer or outsourced to unrelated entities. These expenditures should include salaries, direct costs, patent maintenance costs, overhead costs directly related to R&D facilities, and supply costs. Interest payments, building costs, and acquisition costs are excluded.

This ratio will be calculated on a cumulative expenditure basis and must be updated each year. A taxpayer may limit the amount of overall expenditure to those expenditures incurred beginning as of January 1, 2019. Qualifying R&D expenditures incurred by the taxpayer may be increased by 30%, but the taxpayer's share cannot exceed 100%. The increase does not apply to qualifying expenditures of related parties or the cost of acquiring an I.P. asset.

The nexus ratio is calculated for each financial year and takes into account the expenditures incurred by the taxpayer for that year and prior years for both the numerator and denominator. Consequently, the determination of the nexus ratio requires monitoring all R&D expenditures relating to qualifying assets that have been the subject of the election for this preferential regime.

The 30% buffer does not apply to the qualifying expenditures included in the overall expenditures.

### Stage 3: Application of the Nexus Ratio to The Net Profit

In the final stage, net profits are multiplied by the nexus ratio and the result benefits from the reduced tax rate.

### Safeguard Clause for Exceptional Circumstances

As allowed by the O.E.C.D., France treats the nexus ratio as a rebuttable presumption. It enables taxpayers to prove that more income should be permitted to benefit from the regime in exceptional circumstances.

### Filing Obligations

The company must attach an appendix to the tax return each year, detailing the calculations used to determine the eligible income and the nexus ratio.

Companies must maintain proper documents, including a general description of the organization of the R&D activities and specific information concerning the determination of taxable income. This information must be made available to French tax authorities at the time of examination. Failure to produce the required full documentation within 30 days of receipt of formal notice triggers the imposition of a 5%

fine for each year under examination. The basis of the fine is equal to the income derived from qualifying assets that have been the subject of such breach.

## TAXATION OF CAPITAL GAINS

### **Territoriality**

Capital gains realized on the transfer of French shares by foreign companies are taxable in France if the seller holds a stake of at least 25% of the transferred company at any point within the five-year period preceding the transfer. If an applicable double tax treaty does not provide otherwise, the gain is taxable at normal C.I.T. rate.

A special rule applies to the gains of companies having their place of effective management in an E.U. Member State, or a Member State of the E.E.A. These companies may benefit from an exemption from the Capital Gain Tax (“C.G.T.”), provided that the French company is not a real estate company.

Capital gains realized by foreign seller on transfer of shares in French real estate companies are taxable in France at normal C.I.T. rates, subject to the application of a double tax treaty.

Capital gains realized by a seller located in an N.C.S.T. jurisdiction are subject to 75% tax, no matter the size of the stake maintained in the French company. This treatment is subject to the application of a double tax treaty providing for beneficial treatment of capital gains.

### **C.G.T. on Company Shareholdings**

Gains on the sale of shareholdings (“participations”) are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for capital gains tax relief. Such relief is available in the form of an exemption or a reduced tax rate.

C.G.T. on long-term shareholdings covers gains on the disposal of participations, meaning shares or interests that the shareholder intends to hold as long-term investments, viz., at least two years. The shares must provide the shareholder with control of, or significant influence over, the company.

These tests are deemed satisfied if the shareholder holds a 10% or greater interest. Stock eligible for the D.R.D. (5% interest) and stock received within the course of a public offering are also eligible. Shareholdings in a company that is resident in an N.C.S.T. jurisdiction cannot qualify for the C.G.T. relief.

If for a given year, the capital losses on substantial shareholdings fully offset the capital gains on substantial shareholdings, no tax is due on the capital gains realized. However, because a portion of the exempt capital gain is subject to a 12% add-back, a portion of the gain will be taxed. In essence, the effective tax rate on the gain from the disposal of shares is 3.41%, in the absence of an applicable N.O.L.<sup>26</sup> The 12% addback is calculated from the amount of exempted gross capital gains. Capital losses do not reduce the addback.

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<sup>26</sup> Based on a 27.5% standard C.I.T. rate increased by the 3.3% surcharge mentioned above at **Corporation Income Tax – General**.

### **C.G.T. on Real Estate Holding Companies**

Disposals of shares in a listed real estate holding company (“S.I.I.C.,” which is the French equivalent of a R.E.I.T.), of which more than 50% of the French assets consist of real estate, are eligible for the application of a 19% reduced C.I.T. rate, *i.e.*, a 19.63% effective tax rate, if the substantial shareholding requirements are met.<sup>27</sup> Disposal of shares of unlisted real estate holding companies are subject to the standard C.I.T. rate.

### **C.G.T. on Venture Capital Vehicles**

Capital gains resulting from the disposal of interests in venture capital funds or companies (“F.C.P.R.” or “S.C.R.”) that are held for at least five years are eligible for the C.G.T. exemption, but only in proportion to the investments made by the company and funds in qualifying substantial participations; otherwise, a 15% reduced C.I.T. rate applies (*i.e.*, a 15.45% effective tax rate).

### **C.G.T. on Short-Term Shareholdings – Anti-Abuse Provision for Intercompany Transactions**

Deductions for short-term capital losses incurred upon the transfer of shares held for less than two years to a related party are deferred until the shares are effectively transferred to an unrelated party.

## **ANTI-AVOIDANCE PROVISIONS**

### **General Anti-Avoidance Provisions**

The Finance Act for 2019 introduced several new anti-abuse provisions. The reforms aim at introducing the principal purpose test in French G.A.A.R. without being in breach of the Constitution.

#### **Article L. 64 of the of Tax Procedures Code (“B.T.P.”) – Existing Exclusive Motivation Test**

Under the existing motivation test, the F.T.A. may disregard a transaction on the grounds that (i) it has a fictitious character or (ii) it aims at obtaining a formal application of a legal provision or decision in violation of its purpose and is exclusively motivated by the objective of reducing the taxes which normally would have applied to the actual transaction. Penalties may be imposed that range from 40% for gross misconduct to 80% for tax fraud under §1729 of the F.T.C.

#### **Article L. 64 A of the B.T.P. – Main Abuse of Law**

The Finance Act for 2019 introduced a new abuse of law provision under L.64 A of the B.T.P. that applies to tax reassessments issued since January 1, 2021, relating to transactions carried out from January 1, 2020. Under the new provisions, the F.T.A. may disregard a transaction on the grounds that the transaction aims at obtaining a formal application of legal provisions or decisions in violation of their purpose and is mainly motivated by the objective of reducing taxes which “normally” would have applied to an “actual” transaction.

<sup>27</sup>

This consists of the 19% tax rate increased by the 3.3% surcharge mentioned above.



The scope of the new provision is broader than the scope of §L. 64 of the B.T.P., that applies when the tax savings are the exclusive reason for entering the transaction. The threshold for applying §L. 64 A of the B.T.P. is lower because tax savings need be only a main purpose. In addition, §L. 64 A of the B.T.P. applies to all taxes. Article L. 64 A of the B.T.P. does not provide for specific penalties. However, normal penalties of 40% willful wrongdoing under Article 1729, a) of the F.T.C. should apply.

#### Article 205 A of the F.T.C. – General C.I.T. Anti-Abuse Provision

To comply with Article 6 of the A.T.A.D., France introduced a G.A.A.R. by enacting §205 A of the F.T.C. This provision applies only to corporate income tax and is effective for financial years beginning on or after January 1, 2019. However, transactions initiated before January 1, 2019, may be subject to this new rule if they entail tax consequences over financial years beginning on or after the effective date.

The G.A.A.R. tackles an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances. An arrangement or a series of arrangements will be regarded as nongenuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality.

A parliamentary report issued in connection with the enactment of G.A.A.R. indicates that the term must be interpreted in the light of the case law of the E.C.J. In addition, a private ruling procedure has been introduced to assist companies undertaking specific transactions.

#### Other Specific Anti-Abuse Provisions

Specific anti-abuse provisions apply to the withholding taxes on outbound dividends (§119<sup>ter</sup> of the F.T.C.) and the favorable roll-over tax regime applicable to mergers (§210-A of the F.T.C.). They are derived from the A.T.A.D. and have the same wording as §205 A of the F.T.C.).

The exact demarcation between all newly enacted anti-abuse rules is somewhat nebulous. Guidelines of the F.T.A. published in January 2020<sup>28</sup> tend to confirm that the F.T.A. has discretion as to which standard should be applied in attacking abusive arrangements, with a choice between using the exclusive or the main abuse-of-law provision. In both cases the F.T.A. must initiate a specific procedure.

#### Subject to Tax Limitation

Outbound payments made to foreign entities that are subject to an effective tax rate lower than 40% of what would have been the tax liability in France are nondeductible for tax purposes (Article 238 A of the F.T.C.). The threshold applies to payments of interest, royalties, and remuneration for the performance of services.

Deductibility may be granted if the taxpayer demonstrates that (i) the payments are made for actual operations and (ii) the payments are not abnormal or disproportionate. If the beneficiary is established in an N.C.S.T. jurisdiction, the taxpayer the taxpayer must demonstrate that the payments have a primary effect or purpose other than locating profits in the N.C.S.T. jurisdiction.

<sup>28</sup>

BOI-CF-IOR-30-20.

### Controlled Foreign Corporation (“C.F.C.”) Legislation

Section 209 B is the French counterpart to Subpart F of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d’Etat*, struck down §209 B as discriminatory under the France-Switzerland Income Tax Treaty.<sup>29</sup> The *Conseil* found that §209 B indeed amounted to a tax on French business profits of the foreign company, which, in the absence of a permanent establishment in France, was precluded by the income tax treaty applicable between France and Switzerland at that time. In addition, §209 B was clearly at odds with the principle of free establishment protected by the E.C. Treaty. The French C.F.C. rules were revised.

In its current version, C.F.C. rules apply when a French company or a P.E. located in France holds directly or indirectly more than 50% of the shares of an entity located in a foreign country. It includes legal entities that are or are not distinct from their shareholders, it also includes trusts.

The holding threshold drops to 5% if (a) 50% of the legal entity is held directly or indirectly by other related French or foreign entities that control or are under the control of the first French company<sup>30</sup> or (b) 50% is owned or controlled by unrelated entities acting together.

The new provisions do not replace the current anti-abuse provision, pursuant to which an interest held by “sister entities” (whether French or foreign) is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is effectively subject to C.I.T. at a rate lower than 50% of the French C.I.T. that a French company would have paid on the same income. This threshold is reduced to 40% since January 1, 2020.

If a French entity holding subsidiaries outside the E.U. falls in the scope of the C.F.C. rule, its share in the profits of the C.F.C. are added to French taxable income and treated as “deemed distributions.” In determining the amount of the inclusion, the foreign profits will be recomputed under French standards, and several adjustments must be implemented. Unless specifically addressed, double tax treaties are of no protection against the C.F.C. rule.

N.O.L.’s of the French company are available to reduce the taxable income arising from the attribution of profits from a C.F.C. Also, taxes paid by the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company as credits to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

### E.U. Safe Harbor

C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a wholly artificial arrangement, set up

<sup>29</sup> CE, June 28, 2002, *Ministre de l’Economie, des Finances et de l’Industrie c/ Sté Schneider Electric*, no. 232276, RJF 10/02, no. 1080.

<sup>30</sup> Control means (i) holding directly or indirectly the majority of the share capital of the “controlled” entity, (ii) having the majority of voting rights, directly or indirectly, or (iii) having the power of decision. In addition, the control test is met where a company is *de facto* dependent on the other one, due, for example, to commercial ties.



to circumvent French tax legislation. This provision follows the case law developed by the E.C.J., particularly *Cadbury Schweppes*.<sup>31</sup> In the *Cadbury Schweppes* case, the E.C.J. decided that the C.F.C. was not artificially established when it participated in economic activity in the host country with the required substance and that the subjective intent of the establishment was not material with regard to tax planning.

### General Safe Harbor

A second exclusion (the “Trade or Business Exclusion”) may apply to C.F.C.’s established in non-E.U. countries.

This exclusion provides that C.F.C. rules does not apply if the primary purpose of the operation is not the generation of local profits in the foreign jurisdiction. This condition is deemed fulfilled when the foreign entity conducts effective business operations through a facility in the foreign jurisdiction.

French administrative guidelines provide that the exclusion also applies to entities deriving passive income from financial activities or the management of intangibles unless (i) the passive income comprises more than 20% of the profits of the C.F.C. or (ii) more than 50% of the profits of the C.F.C. are derived from financial activities, the management of intangibles, and services rendered to affiliates. In either case, the French taxpayer must demonstrate that the use of the foreign entity or enterprise does not primarily result in moving profits to a low-tax jurisdiction.

C.F.C.’s established in an N.C.S.T. jurisdiction do not benefit from the trade and business exclusion unless the taxpayer can justify the substance of the business carried out and comply with the 20% and 50% ratios.

### Anti-Hybrid Test

#### Provisions Applicable to Fiscal Years Beginning Before January 1, 2020

In an effort to curb the use of hybrid instruments, France unilaterally introduced an anti-hybrid mechanism. This mechanism disallowed interest expense deductions in cases where it could not be proven that the interest payment was subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax that would have been due in France.

The rate comparison referred only to the tax regime applicable to the gross income received from France. It did not refer to the effective tax rate of the recipient entity. Consequently, expenses and losses that could reduce the taxable result of the foreign company were disregarded when applying this test. Also, negative adjustments to income under foreign tax consolidation regimes were not considered.

The application of the anti-hybrid rule did not preclude application of the French general anti-avoidance rules.

<sup>31</sup>

*Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995; see also *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes)*, Case C-264/96, [1998] E.C.R. I-04695, and guidelines issued by the F.T.A. dated January 16, 2007 (4-H-1-07).

**“The application of the anti-hybrid rule did not preclude application of the French general anti-avoidance rules.”**

### Provisions Applicable to fiscal Years Beginning on and After January 1, 2020

The provisions of E.U. Directive 2017/952 (“A.T.A.D. 2”) have been integrated into French tax law by Finance Act for 2020. These provisions replace the previous subject-to-tax provisions.

The anti-hybrid regime derived from A.T.A.D. 2 tackles tax asymmetries occurring in the course of (i) intercompany payments, (ii) payments between headquarters and permanent establishments, and (iii) payments between permanent establishments of a same entity. These asymmetries include the following transactions:

- Payment pertaining to a financial instrument that leads to a deduction in State A and a non-inclusion in State B, because of an asymmetry of characterization of the instrument or the payment
- Payment made to a hybrid entity that entails a deduction in the State of the payor and non-inclusion in the State of residence of the hybrid entity, because of an asymmetry in the description of the payment between the State of residence of the hybrid entity (no income recognized from a wholly internal transfer) and the State of residence of the stakeholders in the hybrid entity (deduction recognized from a payment to a related entity)
- Payments to an entity having several permanent establishments, that entails a deduction in the State of the payor and no inclusion in the State of residence of the entity, because of an asymmetry of attribution of the payment between the State of residence of the entity (deduction recognized from a payment to a related entity) and the State of the permanent establishment, or among the States in which different permanent establishments are maintained (no income recognized)
- Payments to a permanent establishment that entails a deduction in the State of the payor and no inclusion in the State of the establishment, because the establishment is not recognized in the State of its location
- Deemed payments between a permanent establishment and its headquarters, or between different permanent establishments that entails a deduction in the State of the payor and no inclusion in the State of the beneficiary, because the State of the beneficiary does not recognize the payment
- Deductions allowed in each of two states for the same payment

Such asymmetries will generally trigger the reversal of the tax deduction claimed in France.

A grandfather rule applies to test the interest expense deduction under the subject-to-tax test. Interest payments made to beneficial owners under a grandfathered transaction that is resident abroad and subject to tax at a rate that is at least 25% of the French C.I.T. rate will continue to be deductible, provided that (i) they are supported by valid business rationale and (ii) they do not fall into one of the situations tackled by the A.T.A.D. 2 provisions.

### Non-Cooperative States and Territories

Since 2010, specific French tax legislation addresses French companies entering into transactions with companies that are resident in an N.C.S.T. jurisdiction. This legislation was revised by the Finance Act for 2019, enacted in December 2018.

Under the current version, the N.C.S.T.'s are defined (i) by reference to the French appreciation of the exchange of information and (ii) also by reference to the E.U. list of noncooperative jurisdictions for tax purposes adopted by the Council of the E.U. conclusions on December 5, 2017 and updated periodically.

For purposes of the French list, a country or territory is defined as an N.C.S.T. if it meets the following criteria:

- It is not a Member State of the E.U.
- It has been reviewed and monitored by the O.E.C.D. global forum on transparency and exchange of information.
- It has not concluded 12 or more Tax Information and Exchange Agreements ("T.I.E.A.'s").
- It has not signed a T.I.E.A. with France.

The N.C.S.T. was updated in March 2022 and now encompasses Anguilla, Fiji, Guam, the U.S. Virgin Islands, the British Virgin Islands, Palau, Panama, U.S. Samoa, Samoa, Seychelles, Trinidad and Tobago, and Vanuatu.

For the purposes of the E.U. list, reference is made to decisions of the Council of the E.U. Jurisdictions on the E.U. list are treated differently according to the rationale behind their rostering. Jurisdictions that facilitate offshore structures and arrangements aimed at attracting profits without real economic substance may receive extensive French anti-abuse treatment. In comparison, jurisdictions that do not meet at least one of the criteria on tax transparency, fair taxation, and implementation of anti-B.E.P.S. measures may receive only limited French anti-abuse treatment (so-called "grey list")

On February 24, 2022, the Council of the E.U. revised the E.U. list of noncooperative jurisdictions. After having been added in 2021, Dominica was removed along with Anguilla and Seychelles. The jurisdictions mentioned on the E.U. list may be removed in the future if they make significant efforts to meet E.U. tax standards.

The French tax consequences for transactions with N.C.S.T.'s are effective as from the first day of the third month following the publication of a specific governmental order. As of February 24, 2022, nine jurisdictions were on the E.U. blacklist and 17 were on the E.U. grey list.

The Finance Act for 2019 also introduced several safe harbors shielding transactions with an entity or an account located in an N.C.S.T. that are not mainly intended to attracting profits to an N.C.S.T.

Where one of these countries is involved, French tax law provides for a significantly increased tax rate, tightened anti-abuse of law provisions, or exclusion from favorable tax regimes.

## OTHER TAX ITEMS

### **Cooperation with the Tax Authorities**

#### **Fiscal Partnership and Fiscal Support**

The Act for a Trustful Society of August 2018<sup>32</sup> introduced two services of cooperation between companies and the tax authorities.

#### **Fiscal Partnership**

The fiscal partnership aims at large companies and groups that wish to establish a constant dialogue with the tax authorities regarding strategic or delicate matters. This option is restricted to companies that fulfilled their tax obligations for the three preceding years and have not received any penalty for willful wrongdoing. A tax official is appointed to follow the company and work with the company to identify regulatory issues. The company can correct its mistakes without penalties. The examination of issues leads to the issuance of rulings that bind the tax authorities for the future. The partnership can be terminated without notice or penalty.

#### **Fiscal Support**

The fiscal support aims at S.M.E.'s that seek cooperation on specific operations. This program is available to companies that satisfy the definition of an S.M.E. under E.U. law.<sup>33</sup> The support is addressed to growth companies, innovative companies, or companies that operate in strategic sectors. Like the fiscal partnership, this program is limited to companies that have been compliant for the three preceding years and have not committed willful wrongdoings. An official is appointed by the tax authorities to work with the company to identify the issues that could benefit from a formal position of the authorities. Most notably, it concerns recurring operation with high financial implications, or punctual operation that are key in its development. The position is formalized by a binding ruling from the French tax authorities.

#### **Regularization Service**

This new service is in charge of helping companies and their managers with the regularization of their situation. Eligible demands are limited to (i) irregularities discovered before or after the takeover of a company, (ii) certain issues related to international tax, such as the existence of a P.E., the allowance of a deduction for the payment of outbound interest, and noncompliant arrangements), (iii) the taxation of managers, and (iv) arrangements that expose the company to 80% penalties.

Under the program, the company makes full disclosure to the tax authorities of compliance shortfalls. The company undertakes to comply with future tax obligations. In exchange, taxpayer benefits from lower penalties. The common 80% fraud or abuse of law penalty, the 40% willful wrongdoing penalty, and 10% failure to file penalty are reduced to 30%, 15%, and nil, respectively. Late payment interest will also be reduced by 40% or 50% for the absence of filing.



<sup>32</sup> Loi 2018-727, 10 August 2018, art 17.

<sup>33</sup> Meaning less than 250 employees and a turnover lower than €50 million, or a balance sheet that does not exceed €43 million.

The program is initiated by the taxpayer. It must be initiated prior to the start of an audit or the receipt of an inquiry from the French tax authorities. The taxpayer submits an information packet that accompanies its request for relief. The tax authorities may request additional information, and if resolution is not obtained with the officer assigned by the tax authorities, the case can be appealed to a higher ranking official.

### **Fraud Act**<sup>34</sup>

The Fraud Act of October 23, 2018, gives significant tools to the F.T.A. in its fight against tax avoidance and tax fraud.

### **Name and Shame**

The F.T.A. may publish information regarding tax penalties imposed on a company, as a result of a fraudulent arrangement or abusive transaction, when the amount equals or exceeds €50,000. Before information on the penalties can be published, the F.T.A. must obtain the approval of a special commission that is empowered to review tax offences (*“commission des infractions fiscales”*). If approval is given, the corporation is allowed a period of 60 days to lodge an appeal, which suspends publication. If no appeal is lodged, the name of the taxpayer and the amount of penalties imposed will be listed on the F.T.A. website. The publication lasts for not more than one year. The F.T.A. must also publish any court decision in favor of the company if the assessment is successfully challenged in court.

### **Tax Offenses and Criminal Prosecution**

The Fraud Act, which came into effect on October 24, 2018, introduced major changes in the criminal prosecution of tax offenses. Under prior law, the F.T.A. exercised discretion in choosing the cases to transfer to the public prosecutor. Now, the F.T.A. must report all tax cases to the public prosecutor involving reassessments exceeding €100,000 (€50,000 for certain taxpayers) and the assertion of the following civil penalties:

- 100% tax penalties imposed because the taxpayer took steps to prevent the tax audit,
- 80% tax penalties imposed because the taxpayer took steps to hide assets or income, committed tax fraud, followed a plan that amounted to an abuse of law, failed to declare assets located abroad, or secretly placed assets in a foreign trust, and
- 40% tax penalties imposed because the taxpayer failed to pay tax within 30 days of a notice, took action amounting to deliberate misconduct or abuse of law.

The public prosecutor decides whether to pursue a criminal investigation.

The F.T.A. retains discretion to report matters that do not fall within the foregoing categories.

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<sup>34</sup>

*Renforcer Les Moyens Alloués À La Lutte Contre La Fraude Fiscale, Sociale Et Douanière*, LOI no. 2018- 898, October 23, 2018.

Upon approval by the *commission des infractions fiscales*, the F.T.A. may recommend cases to the public prosecutor for criminal prosecution. In these cases, a criminal complaint must be lodged within six years of the close of year in which the offense was committed. Once the criminal investigation begins, the discovery of new facts of tax fraud committed by the same taxpayer, including those related to other years or other taxes, may expand the scope of the investigation.

Conviction of the criminal offense of tax fraud may result in a penalty of up to €500,000 penalty and a prison term of up to five years. The penalty may increase to €3 million in cases involving complex frauds and organized frauds. The criminal penalties are applied in addition to civil tax penalties.

The Fraud Act provides that the penalty may be increased to twice the financial benefit derived by the defendant.

### **Advisor's Disclosure and Penalties**

#### **Law on Reinforcement of The Fight Against Fraud**

The Fraud Act introduced a disclosure obligation for legal and accounting advisors involved in the design or implementation of aggressive tax planning arrangements. Advisors who assist taxpayers with transactions that result in the 80% civil penalty may face their own penalty exposure. The amount of the fine is the greater of 50% of the advisor's fees or €10,000.

#### **Directive 2018/822**

France has transposed the E.U. Directive 2018/822<sup>35</sup> ("D.A.C. 6") into its national law. This Directive created an obligation for intermediaries to report certain potentially aggressive cross-border tax planning arrangements to tax authorities within 30 days of implementation. This Directive adopts broad definitions of both intermediaries and reportable cross-border arrangements.

An intermediary is anyone who designs, markets, organizes, makes available, or implements a reportable arrangement or anyone who helps with reportable activities and knows or could reasonably be expected to know the effect of their advice. The targets are lawyers, in-house counsel, underwriters, capital providers, insurance brokers, accountants, and financial advisors.

Reportable cross-border arrangements contain at least one of the hallmarks listed in D.A.C. 6 as indicative of a potential risk of tax avoidance. If an intermediary is unable to submit a report due to a professional privilege recognized under law, the obligation to disclose falls on the taxpayer. Advisors must inform clients involved in a reportable transaction of their obligation to disclose.

Arrangements implemented between June 25, 2018, and July 1, 2020, had to be reported by February 28, 2021. Arrangements subject to declaration obligations due between July 1, 2020 and December 31, 2020 had to be reported by January 31, 2021.

***"Conviction of the criminal offense of tax fraud may result in a penalty of up to €500,000 penalty and a prison term of up to five years."***

<sup>35</sup>

Council Directive 2018/822/E.U. Amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2018 O.J. L 139/1.

D.A.C. 6 has been transposed in Article 1649 AD to AH of the F.T.C. The French tax authorities have issued guidelines on its scope of application and on the relevant definition of the hallmarks in November 2020.<sup>36</sup> The reporting obligation applies to eligible operations implemented since June 25, 2018. Information seems to reveal that the French market has been shy in filing D.A.C.6 reports in comparison to other E.U. countries.

### Transfer Pricing

The arm's length principle applies to transactions between related parties. France follows the O.E.C.D. guidelines.

Transfer pricing documentation is mandatory in France for taxpayers that fit into one of several categories:

- French companies with a gross annual turnover or gross assets equal to or exceeding €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.
- 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 corresponds to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European Commission ("the Commission"). It must include (i) general information about the group and its subsidiaries, known as the master file and (ii) detailed information on the French audited company, such as a description of its activities and transactions, including a presentation of the transfer pricing method used to test controlled transactions. The latter is known as the country-specific file. This documentation must be presented to the F.T.A. when the company is audited.

If the company fails to provide the documentation, a fine amounting to the greatest of €10,000, 5% of adjusted profits,<sup>37</sup> or 0.5% of the amount of the transactions may be imposed.

Entities described below must electronically file an annual simplified transfer pricing form within the six-month period following the filing of their tax return:

- French companies with a gross annual turnover or gross assets equal to or exceeding €50 million
- French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €50 million threshold

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<sup>36</sup> BOI-CF-CFP-30-40.

<sup>37</sup> The actual rate will depend on the behavior of the company.



- French parent companies that directly or indirectly own at least 50% of companies meeting the €50 million threshold
- Worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €50 million criteria within the perimeter)

Where transactions carried over from affiliated companies involve amounts below €100,000 per type of transaction, the simplified transfer pricing documentation is not required.

The law does not provide a specific penalty for the failure to file. Therefore, the general penalty of €150 per document provided by 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.

For companies not subject to the mandatory transfer pricing documentation, the F.T.A. may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company, and details regarding the activities of the nonresident affiliated companies and the tax regime applicable to them.

In order to avoid uncertainty, taxpayers may reach an advance transfer pricing agreement with the F.T.A. The advance pricing agreement could be unilateral, bilateral, or multilateral. The French program is efficient and pragmatic.

Finally, in accordance with the O.E.C.D.'s B.E.P.S. Action Plan, the Finance Bill for 2016 introduced Country-by-Country ("C.b.C.") Reporting obligations for French companies that (i) control foreign subsidiaries or have permanent establishments overseas and (ii) have a consolidated turnover exceeding €750 million. The taxpayer must report the activities and places of activity of the entities in the group and information about profit splitting among these entities. The goal of C.b.C. reporting is to provide tax authorities with an overview of the states where expenses, income, and profits are located, and are likely to support future reassessments.

According to Article 223-*quinquies* C of the F.T.C., C.b.C. reporting is mandatory for international groups that meet the turnover threshold and have either a French permanent establishment or a French subsidiary except when they are subject to a similar obligation in their respective country of residence. French entities that are held by foreign companies subject to a similar obligation in their respective country of residence are not subject to C.b.C. reporting in France.

The reporting obligations must be fulfilled within 12 months after the closure of the annual accounts. Failure to comply with the requirements will trigger the imposition of a penalty which cannot exceed €100,000 for each violation.

A European directive<sup>38</sup> provides for a similar mechanism at the E.U. level. Under the directive, the mandatory exchange of information between the European tax

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<sup>38</sup> Council Directive 2016/881/E.U. amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2016 O.J. L 146/8.



administrations is extended to include the automatic exchange of information on the C.b.C. Report.

### **Transfer Taxes**

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares, the following rates generally apply:

- A fixed tax rate of 0.1% applies to transfers of shares of stock issued by a French S.A., S.C.A. or S.A.S. – except if the entities qualify as real estate holding companies for tax purposes. Also, 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 shares of stock are subject to a fixed transfer tax rate of 3%. A relief equal to €23,000 divided by the total number of units issued by the entity is applied to the taxable value of each unit.
- Transfers of shares issued by French real estate holding companies – irrespective of their legal form – are subject to a 5% transfer tax.
- Transfers of shares issued by foreign-deemed-French real estate holding companies are also subject to a 5% transfer tax. In addition, the transfer should be documented and executed by and before a French notary, unless the documentation is executed in France by the parties or their representatives.

Regarding the sale of assets, the following rates generally apply:

- Transfers of real property assets located in France are subject to tax at a rate of 5.09% or 5.81%.<sup>39</sup> A 0.6% additional tax applies to the sale of assets allocated to a commercial purpose (e.g., offices, retail, or storage) that are located in the Île-de-France region (and in some cases, such transfers may be subject to V.A.T. instead).
- A progressive tax rate applies for transfers of business as going concerns (“*fonds de commerce*”) or goodwill: (i) 0% for the portion of the transfer price below €23,000, (ii) 3% for the portion between €23,000 and €200,000, and (iii) 5% for the portion exceeding €200,000.

## **B.E.P.S., A.T.A.D., AND FRANCE**

### **B.E.P.S.**

France is one of the founding members of the O.E.C.D. and is highly involved in the O.E.C.D.’s work relating to the B.E.P.S. Project. Soon after the publication of the O.E.C.D. report entitled “Addressing Base Erosion and Profit Shifting” in February 2013, the Parliament Commission of Finances released a report on the same topic, which reaffirmed the prevention of tax evasion and tax fraud as a priority for the French government and formally endorsed the B.E.P.S. Project. The French government actively encourages the E.U. to act on these issues.

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<sup>39</sup> The tax rate applicable depends on the location of the asset.

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.

In the context of the digital economy, the French government places high priority on (i) the elimination of inappropriate double nontaxation, (ii) the reinforcement and effectiveness of anti-avoidance rules, and (iii) addressing profit shifting issues. B.E.P.S. issues are regularly debated in commissions and assemblies of French Parliament, and several legal provisions have been introduced in recent finance bills. These include the following:

- The modification of the abuse-of-law provisions from an *exclusively* tax-driven test to a *principally* tax-driven test.
- The amendment of the I.P. box regime to comply with the “nexus approach” preconized by the O.E.C.D.
- The limitation of the D.R.D. regime to exclude dividends that were deducted from the distributing company’s taxable income<sup>40</sup> and dividends that are paid when the ownership structure cannot be considered genuine because it is not justified by a valid commercial reason.
- The anti-hybrid mechanism, which disallows interest in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one quarter of the tax which would have been due in France.
- The annual C.b.C. Reporting requirements for French companies controlling foreign entities or having permanent establishments overseas.

The French government is highly involved in the B.E.P.S. Project at the level of the O.E.C.D., as well as at the level of the E.U., and it is expected to be a pioneer in implementing new regulations that may be proposed to combat B.E.P.S. within either organization, or at a federal level.

Recent experience in tax examinations indicates that tax examiners take positions based on the current work of the O.E.C.D. regarding B.E.P.S., even if those positions are not compliant with current tax law. Such action gives rise to questions of potential double taxation unless a multilateral policy is adopted.

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Transposition of Council Directive 2014/86/E.U. of July 8, 2014.

*“Companies within the scope of the directive are tagged as companies at risk.”*

## **A.T.A.D**

On July 12, 2016, the European Council adopted the A.T.A.D.<sup>41</sup> The scope and the measures of this Directive regarding hybrid mismatches were further enlarged by the A.T.A.D. 2 of May 29, 2017.<sup>42</sup>

A.T.A.D. builds on the principle that tax should be paid where profits are made. It includes legally binding measures to block the methods most commonly used by companies to avoid paying tax. It also proposes common definitions of terms such as permanent establishment, tax havens, transfer prices, royalty costs, patent boxes, and letterbox companies.

France transposed several A.T.A.D. provisions through the Finance Bill for 2019. This transposition also repealed the *rabot* (25% haircut limitation), the Carrez Amendment, and the thin capitalization rules. In addition, dispositions of A.T.A.D. 2 regarding G.A.A.R. and anti-hybrid were transposed in the F.T.C.

E.U. Member States were required to conform domestic legislation with the A.T.A.D. provisions by December 31, 2018. France has implemented comparable but not totally similar anti-abuse provisions regarding, *inter alia*, C.F.C. rules and exit taxation. A transitional extension is granted to E.U. Member States that have already implemented targeted rules for preventing B.E.P.S., provided those rules are equally effective as the A.T.A.D. provisions. France has taken advantage of this relief.

## **Proposal for A.T.A.D III**

On December 22, 2021, the European Commission published a proposal for a directive<sup>43</sup> to harmonize minimal substance tests for holding companies within the E.U. The proposal defines minimum substance criteria for companies in its scope and creates reporting obligations and sanctions.

The deadline for transposition by Member States will be June 30, 2023 with application from January 1, 2024. However, the majority of the criteria would be assessed over the two financial years preceding the application of the directive, *i.e.*, 2022 and 2023.

Companies within the scope of the directive are tagged as companies at risk. This would apply to the following cases:

<sup>41</sup> Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1.

<sup>42</sup> Council Directive 2017/952/E.U. Amending Directive 2016/1164/E.U. As Regards Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

<sup>43</sup> Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/E.U., December 22 2021, COM (2021) 565 final.

- More than 75% of the income derived by the company includes listed passive income.<sup>44</sup>
- More than 60% of the book value of company's immovable property or private movable property (of which the book value is higher than €1 million, other than cash, shares, or securities), is located outside of the Member State of its residence, or more than 60% of the income derived from listed passive income is cross-border income.
- The company outsourced the administration of day-to-day operations and decision-making on significant functions.

The directive would provide for specific exemptions.

The company at risk would have to declare in its annual tax return whether it meets the following indicators of minimum substance:

- Having its own premises or premises for its exclusive use in the Member State
- Having at least one owned and active bank account in the E.U.
- Having at least one qualified director residing in the Member State (or a border State) who regularly makes decisions relating to passive income, without being an employee or director of third-party companies

Where one of the indicators of minimum substance is not met, the company would be considered a “shell entity” unless it can demonstrate (i) the commercial rationale behind the establishment of the company, (ii) concrete evidence of local decision-making concerning the activity generating the income, and (iii) the actual activities of the employees and their qualifications.

The consequences of being considered a shell entity are (i) the elimination of tax advantages related to the establishment of the company in the source-income state and the beneficial owner state, (ii) the inability to obtain tax certificates for the benefits of tax treaties, and (iii) tax transparency treatment for the shell entity. Furthermore, information related to the shell entity's identification or exemption would be gathered in a central directory to which tax administrations would have to send information in the 30 days following the company's reporting obligation.

Penalties for noncompliance may include at least 5% of the shell company's turnover.

The proposal gives rise to many questions, especially in relation to the definition of the decision-making on significant functions for holding companies.

Information on companies within the scope of the directive, even those with sufficient substance, will be available to all Member States unless the company can

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The list includes interest or other income generated from financial assets, including crypto assets, royalties, dividends and income from the disposal of shares; income from financial leasing; income from immovable property; income from movable property other than cash, shares, or securities held for private purposes and with a book value of more than €1 million; income from insurance, banking, and other financial activities; and income from services which the undertaking has outsourced to other associated enterprises.



justify that it provides no tax benefit to the U.B.O. and the group. The Member State that is the source country of any income or the residence country of the U.B.O. would not be deprived of the ability to apply their own G.A.A.R. or any other anti-abuse mechanisms.

Amendments are likely to be discussed.

## COVID-19 RELATED MEASURES

### **Emergency Measures Related to COVID-19**

Several emergency measures were taken in 2020 to help French businesses through the health crisis.

#### **Tax Deadlines Postponement**

Most filing deadlines pertaining to companies were postponed to June 30, 2020 for companies with fiscal year ending March 30, 2020. It primarily concerned corporate income tax, C.V.A.E., and D.A.S.2. However, no postponement was applied to V.A.T. filings.

Declaration of the transfer pricing policy was also postponed.

#### **Suspension of Tax Audits**

The tax audits and proceedings were suspended between March 2020 and August 2020 on account of the health crisis.

#### **Suspension of Procedural Deadlines**

The government established a “legally protected period,” starting on March 12, 2020 until August 24, 2020.

#### **For Taxpayers**

During this period, no tax audit could be initiated and the delays for the different acts of procedure were suspended. In practice, this meant the following:

- The time limits that began to run before March 12 were resumed after August 24.
- The time limits that began to run after March 12 only began to run from August 24.

#### **For Tax Authorities**

The suspension of the tax audits entailed the suspension of the auditable period. This period is generally of three years for companies (C.I.T., V.A.T.). Since the audits were suspended between March 12 and August 23, the auditable periods were also suspended during this period. This measure only concerned periods that would have been statutory barred on December 31, 2020, generally for taxes due for 2017. The tax authorities had until June 14, 2021 to reassess taxes that should have been statute barred on December 31, 2020.

### *Tax Payment Deferral for Companies*

Companies could ask for the deferral of the monthly installments of direct taxes upon simple demand addressed to the tax authorities. Taxes covered related to corporate income tax, tax on salaries, real estate contribution. Deferral was granted without penalties or justifications for three months.

Businesses meeting coronavirus-induced difficulties which could not be remedied by the tax payment deferral, could apply for rebates on direct taxes (C.I.T., C.F.E., C.V.A.E.), penalties or late interest by proving their distressed financial situation. The criterion of distress was strictly assessed by the tax authorities.

### *Ban on Dividend Distributions for Large Companies*

Large companies or groups that applied for tax deferrals or support on short time working had to renounce the payment of dividend distributions between March 27, 2020, and December 31, 2020. This applied to companies and groups with more than 5,000 employees or with consolidated turnover in excess of €1.5 billion in France. This covered (i) dividends paid in cash or shares, (ii) any other forms of distributions such as interim dividends or exceptional distribution of retained earnings, and (iii) share buy-backs. Distributions declared before March 21, 2020, and dividends distributed within the group to support French companies were authorized.

Failure to comply with this commitment entailed the immediate payment of deferred taxes, plus late payment penalties that include a 5% penalty plus 0.2% per month starting from the standard liability date.

### *Exceptional Reporting and Payment Procedures of V.A.T.*

Depending on the scale of the estimated decline, companies could declare and make a down-payment of V.A.T. in April, in relation to March, equal to

- 50% of the amount due for February if the business stopped operating from mid-March or the decline in turnover was estimated to be at least 50%; and
- 80% of the amount due for February for other companies whose turnover had fallen, but to a lesser extent.

For companies facing practical difficulties to compute the exact amount of V.A.T. due, there was a possibility to declare and pay based on an estimate (20% margin of error) without penalty.

### *Reduction of the V.A.T. Rate for Certain Products*

V.A.T. rate was reduced from 20% to 5.5% for domestic supplies, intra-community acquisitions and imports of masks, protective clothing and personal hygiene products used to limit the spread of the COVID-19 virus:

- For imports, this rate applied from April 27, 2020.
- For domestic and intra-community supplies, this rate applied retroactively to March 24 for masks and protective clothing, and to March 1 for personal hygiene products.
- The reduced V.A.T. rate should apply until December 31, 2021.

*“For tenant companies, the debt write-off constituted taxable income which offset the corresponding rental charge.”*

### Acceleration of the Payment of Invoices by Public Services

Tax authorities must accelerate the payment of outstanding debts toward taxpayers. This covered V.A.T. credits, competitiveness and employment tax credits, and R&D tax credits. Prompt payment of other invoices by the State, local authorities and government agencies was also mandated. This measure applied to all tax credits refundable in 2020.

### Rent Write-Offs

Landlords that wrote-off rents between April 15, 2020, and December 31, 2020 to help tenants experiencing cash-flow difficulties in the context of the COVID-19 crisis were able to deduct those write-offs from their taxable profits, without commercial justification, unless there was a dependency relationship with the tenant company. The debt write-off increased the ceiling of €1 million for the allocation of previous deficits.

For tenant companies, the debt write-off constituted taxable income which offset the corresponding rental charge.

### Solidarity Fund to Support Small Businesses

A solidarity fund was established with governmental and regional funding to support companies in the sectors most impacted by the health crisis. The aid comprised two tranches. The first tranche allowed a business to receive aid in an amount equal to the declared loss in turnover for March 2020 and April 2020 up to a limit of €1,500. This sum was tax-exempt. The second tranche allowed businesses that benefited from the first tranche and that had at least one employee to receive an additional lump-sum between €2,000 and €5,000 in the event that they had been refused an application for a cash loan of a reasonable amount requested to their bank after March 1, 2020, to cover the shortfall between their available cash resources and the sum of (i) their debts due within 30 days and (ii) the amount of their fixed expenses due in respect of the months of March and April 2020.

The €1,500 allowance was available from March 31, 2020, to companies with less than 10 employees (excluding those belonging to a group of companies), with 2019 turnover of less than €1 million and an annual taxable profit of less than €60,000 for the last financial year closed. To claim the allowance, the company must either suffer from a ban on receiving members of the public over the period or a turnover loss of at least 50 % for this period. Also, the company must have started its activity before 1 February 2020 and not be in judicial liquidation as of March 1, 2020.

### Overtime Hours

When realized during the health crisis, overtime hours were exempted from income tax and social security contributions up to an increased amount of €7,500. In general, the cap is €5,000.

## MEASURES REGARDING FRENCH TAX RESIDENCE

The tax authorities clearly specified that a temporary stay in France due to lockdown or a local travel ban was not likely to result in French tax residence under Section 4 B-1 of the French tax code by relying on CE 3 November 1995 #126513, Larcher.

Additionally, agreements were reached with Belgium, Italy, Germany, Luxembourg, and Switzerland to prevent travel restrictions arising in connection with COVID-19 from changing the place where French cross-border workers are taxed. Thus, working days spent at home from March 14, 2020 and until June 30, 2021 would not be taken into account for the calculation of the number of days that cross-border employees can work from home without being taxed by their home country.

### **Recovery Package Measures**

During Q3 and Q4 2020, the French Parliament voted several tax measures as part of the recovery package aiming at helping the French economy.

#### **Early Repayment of Carryback Receivables**

An amending Finance Bill voted during the summer 2020 provided the possibility for corporate taxpayers to request the immediate repayment of their outstanding carryback receivables as well as the carryback receivable resulting from the use of 2020 tax losses against 2019 taxable profits.

#### **Reduction of the Property Tax Basis for Industrial Establishments**

The French property tax is based on the rental value of the properties. The Finance Bill for 2021 proposed to modernize the parameters of the method used to assess the rental value of industrial establishments by modifying the rates applicable to the cost price of various components of industrial facilities. This significantly reduced property taxes.

#### **Possible Elimination of the Taxation arising from Revaluation of Assets**

The Finance Bill for 2021 introduced a temporary measure allowing companies conducting a revaluation of their tangible and financial assets to opt for the exclusion of the unrealized capital gain from the taxable income of the fiscal year of the revaluation. For amortizable fixed assets, the taxation of the unrealized capital gain is spread over 15 years for constructions or five years for other amortizable fixed assets. Amortization and provisions booked during subsequent fiscal years must be calculated on the basis of the revalued values. For non-amortizable fixed assets, the taxation of the unrealized capital gain is deferred until disposal of the assets. Provisions for depreciation booked during subsequent fiscal years must be calculated based on non-revalued values.

This temporary measure applies to the first revaluation incurred during a fiscal year ending between December 31, 2020 and December 31, 2022.

#### **Possible Spread of the Taxation of Capital Gains related to Sale and Lease-back Operations**

The Finance Bill for 2021 restored and modified the possibility to spread the taxation on the capital gain made upon sale and lease-back operations. The spread is possible for a maximum period of 15 years and is only applicable to sales of buildings preceded by a sale agreement dated between September 28, 2020 and December 31, 2022. This temporary measure is only applicable to buildings allocated to the lessee's business activity.



### Unlimited Carryback Options

In principle, 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 with a maximum €1 million offset.

The Amending Finance Bill for 2021, which entered into force in July 2021, provided a temporary change in the carryback rules allowing an unlimited use of tax losses recognized during tax years closed between June 30, 2020, and June 30, 2021, (*i.e.*, the €1 million limit does not apply) and which can be exceptionally offset against the taxable result realized in the three previous tax years (*i.e.*, the limitation to the immediately preceding tax year would not apply). The corresponding tax credit can be computed according to the 25% C.I.T. rate applicable as of tax years opened on January 1, 2022.

The carryback receivable could be used according to the standard rules.



# ITALY

## Author

Luca Rossi  
Facchini Rossi Michelutti  
Milan

## CORPORATE TAX RATE

As with any Italian-resident company, an Italian-resident holding company is subject to corporation income tax (“I.R.E.S.”) levied on the worldwide income of the company at a flat rate of 24%, as provided in the Income Tax Code (“I.T.C.”).<sup>1</sup>

A regional tax on productive activities (“I.R.A.P.”) also applies to the net value of production performed in Italy. This tax is imposed at the general rate of 3.90%.<sup>2</sup> Higher rates are applicable to banks and other financial institutions (4.65%) and to insurance companies (5.90%). In addition, different regions of Italy may provide for a 0.92% variation of the above-mentioned rates.<sup>3</sup>

Starting from fiscal year 2020, a tax on digital services (“Web Tax”) was introduced by Article 1 (35) of Law n. 145 of December 30, 2018 further amended by Article 1 (678) of Law dated December 27, 2019 n. 160 and by Article 5 (15) of Law Decree dated March 22, 2021 n. 41.<sup>4</sup> The Web Tax is levied on revenues coming from the supply of certain digital services at the rate of 3% and it is applicable to enterprises which have realized, on a worldwide base, revenues of at least €750 million and, in Italy, revenues of at least €5.5 million coming from qualifying digital services.<sup>5</sup>

Starting in fiscal year 2018, a new definition of holding company was introduced in new Article 162-*bis* of I.T.C., introducing a distinction between financial holding companies and non-financial holding companies for I.R.E.S. and I.R.A.P. purposes.<sup>6</sup> According to Article 162-*bis* (3) of I.T.C., a holding company qualifies as industrial when its activity is mainly directed to the acquisition and managing of shareholdings in companies not qualifying as financial institutions. A holding is deemed to carry on mainly such activity if the value of shareholdings in companies other than banks

<sup>1</sup> Presidential Decree dated December 22, 1986, n. 917. Pursuant to Article 1 (61-65) of Law n. 208 of December 28, 2015, as of 2017 (i) the corporation income tax rate has been reduced from 27.5% to 24% and (ii) a 3.5% surtax became applicable to banks and financial institutions (including holding companies of banks and financial institutions but excluding management companies of undertakings of collective investments).

<sup>2</sup> Legislative Decree n. 446 dated December 15, 1997.

<sup>3</sup> Article 16 of Legislative Decree n. 446 of December 15, 1997, as amended by Law Decree n. 66 of April 24, 2014, converted into Law n. 89 of June 23, 2014.

<sup>4</sup> Converted into Law n. 69 of May 21, 2021.

<sup>5</sup> The technical rules for the application of the Web Tax are set out in the Provision of the Director of the Italian Revenue Agency dated January 15, 2021.

<sup>6</sup> Article 162-*bis* of I.T.C. was introduced by Article 5 of Legislative Decree n. 142 of November 29, 2018, which implemented the Anti-Tax Avoidance Directive (E.U.) 2016/1164, as modified by Directive (E.U.) 2017/952 (hereinafter, the “A.T.A.D. Decree”).

and other financial institutions (plus the value of other assets connected with the same shareholdings such as credit granted to those subsidiaries) is more than 50% of the total asset value resulting from the latest approved financial statement.<sup>7</sup> A holding company that is legally classified as an Italian fixed capital investment company (*i.e.*, a *società di investimento a capitale fisso*, or “S.I.C.A.F.”) is subject to the tax regime applicable to undertakings for collective investment. See generally the discussion of collective investment vehicles, below, at **New Patent Box Regime**.

## DIVIDEND EXEMPTION

### Domestic Dividends

In general, the I.T.C. provides for a 95% exemption with regard to dividend distributions received from a domestic Italian company, whereby no withholding tax is imposed, and the effective tax rate is 1.2%.<sup>8</sup> There are no minimum ownership or holding period requirements.

For companies adopting I.A.S./I.F.R.S. accounting principles, profits received from shares, or other financial assets qualifying as “held for trading” are fully taxable.<sup>9</sup> These companies must determine the positive and negative components of their tax base according to I.A.S./I.F.R.S. criteria, as the accounting standards prevail over the ordinary I.T.C. rules (known as the “Derivation Principle”).

When applying the Derivation Principle, the timing accrual principle and the qualification and classification criteria provided by the I.A.S./I.F.R.S. accounting methods are relevant in the calculation of the taxable base. The same principle does not apply to the evaluation and quantification criteria stated by the I.A.S./I.F.R.S. The Derivation Principle has also been extended to companies drawing up their financial statements pursuant to the Italian Civil Code and Italian generally accepted accounting principles (“G.A.A.P”), with few exceptions.<sup>10</sup>

### Foreign Dividends

According to Article 89(3) I.T.C., the 95% exemption is also applicable to foreign-source dividends provided that the payment is not deductible by the payer in its country of residence. Nondeductibility must be stated by the foreign company in a declaration or must result from other objective evidence.

Dividends derived by Italian companies from subsidiaries resident in a country or territory characterized as having a privileged tax regime (a Blacklist jurisdiction, as defined) are fully taxable, unless income has been already taxed in the hands of the Italian recipient under the applicable controlled foreign corporation (“C.F.C.”) rules<sup>11</sup>

<sup>7</sup> As clarified by the Italian tax authority in Ruling Answer n. 40 of January 13, 2021, such an asset test should be computed with reference to the financial year coinciding with the tax period covered by the relevant tax return.

<sup>8</sup> See Article 89(2) I.T.C. Pursuant to Article 1 (62) of Law n. 208 of December 28, 2015, as of 2017, the corporation income tax rate has been reduced from 27.5% to 24%. Therefore, the effective tax rate on dividends is 1.2% ( $0.05 \times 0.24 = 0.012$ ).

<sup>9</sup> See Article 89(2-*bis*) I.T.C.

<sup>10</sup> See Article 83, I.T.C. as modified by Article 13-*bis* (2) of Decree n. 244 of December 30, 2016.

<sup>11</sup> In this case, a foreign tax credit will be available for taxes paid on C.F.C. income.

or a favorable ruling is obtained from the Italian tax authorities, in which case no income is included.

According to Article 47-*bis*,<sup>12</sup> a foreign tax regime – other than a tax regime of an E.U. Member State or an E.E.A. Member State that has signed an agreement with Italy allowing the effective exchange of information – is considered to be a Blacklist jurisdiction in one of two fact patterns:

- The first fact pattern relates to a C.F.C as defined below at **C.F.C. Legislation**. If the foreign company paying the dividend is a C.F.C., the foreign country in which it is resident will be considered to be a Blacklisted jurisdiction if the C.F.C. is subject to an effective tax rate that is less than 50% of the effective tax rate that would be applicable if the same entity were resident in Italy for tax purposes.
- The second fact pattern relates to a foreign company that is not a C.F.C. Here, the foreign country will be considered to be a Blacklisted jurisdiction if the subsidiary is subject to a nominal income tax rate that is less than 50% of the applicable Italian tax rate, taking into account special tax regimes.

To receive a favorable ruling, the taxpayer must demonstrate that the investment was not made for the purpose of obtaining the benefits of a preferential tax regime. If the Italian corporation fails to demonstrate that the investment was not motivated by an intent to benefit from the preferential tax regime, it may be able to deduct 50% of the dividend provided it proves that the distributing company carries on a substantial economic activity supported by staff, equipment, assets, and premises.<sup>13</sup> Effective 2015, the advance ruling is no longer mandatory, provided that the abovementioned conditions 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.<sup>14</sup> Substantial penalties are imposed for a failure to disclose.

Dividends corresponding to profits already taxed in the hands of an Italian-resident controlling company under the C.F.C. rules are not taxed again upon actual receipt. Again, see **C.F.C. Legislation** for a discussion of C.F.C. rules.

Full taxation applies only to Blacklist dividends derived directly from a participation in a subsidiary that is resident in Blacklist jurisdiction or through a C.F.C. in a non-Blacklist country with Blacklist-resident participations.

## 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.

<sup>12</sup> This Article was introduced by Article 5 of the A.T.A.D. Decree, and it entered into force in 2018.

<sup>13</sup> In this case, a foreign tax credit is granted to the controlling company pursuant to 165 I.T.C., discussed below at **Branch Exemption Regime**. See Article 89(3) I.T.C., as substituted by Article 5 of Legislative Decree n. 142 of November 29, 2018.

<sup>14</sup> See Article 89(3) I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015.



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 after the holding period begins for the shares.
- The subsidiary must be tax resident in Italy or in a country that is not a Blacklist jurisdiction or territory, as described above at **Domestic Dividends** and **Foreign Dividends**. 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. Such condition must be continuously verified starting from the first period of ownership of the participation (or, starting from the fifth fiscal year preceding the disposal of the participation, where such disposal occurred in favor of third parties).<sup>15</sup> 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 a company resident in a Blacklist jurisdiction must be disclosed on the Italian tax return.<sup>16</sup>
- The subsidiary must have been engaged in an active business for three or more years preceding the financial year of the sale, unless the shares are traded on a stock exchange.

Several conditions apply to the foregoing tests. Under the anti-avoidance rules, a company is deemed not to be carrying out an active business if real estate is the predominant asset 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 the portion of costs related to the taxable portion of the sale is deductible, *viz.*, 5%.

## INTEREST DEDUCTION

The A.T.A.D. Decree redefined the interest deduction regime for companies subject to I.R.E.S., starting from 2019.

The interest deduction regime, in general, provides as follows:<sup>17</sup>

- Interest expense is fully deductible against interest income in each tax period.
- The interest expense in excess of interest income results in net interest expense. The net interest expense can be deducted subject to a cap of 30% of an amount substantially corresponding to earnings before interest, taxes, depreciation, and amortization (“E.B.I.T.D.A.”). E.B.I.T.D.A. must be quantified on the basis of the relevant tax values, *i.e.*, reflecting the corporate income tax adjustments applied to E.B.I.T.D.A. computed for accounting purposes.

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<sup>15</sup> See Article 87(2), as modified by Article 5 of the A.T.A.D.

<sup>16</sup> *Id.*, Article 87(1).

<sup>17</sup> See *id.*, new Article 96.

- The amount of interest expense that exceeds the 30% limit is not deductible in the tax period incurred, but may be carried forward indefinitely until it can be absorbed in a year when sufficient E.B.I.T.D.A. exists.
- The excess of interest income over interest expense in a fiscal year may be carried forward and applied when determining net interest expense of following periods.
- The excess deduction capacity is the amount by which 30% of E.B.I.T.D.A. exceeds net interest expense. This capacity may be carried forward and used to increase the deduction capacity in the following five periods.<sup>18</sup>

Financial intermediaries such as banks and insurance companies and their holding companies and certain other financial institutions are excluded from the interest deduction limitation regime. Separate specific rules apply to banks and insurance companies. Under Article 162-*bis* (2) of I.T.C., a holding company qualifies as a financial intermediary when more than 50% of its total assets consist of investments in shares of other financial intermediaries and related assets such as intercompany receivables (see **Corporate Tax Rate**).

Consequently, the limitation regime applies to industrial holding companies that maintain participations in other entities that do not carry on lending activities or financial services to the public.<sup>19</sup> Industrial holding companies that participate in a domestic consolidation for tax purposes in Italy may compute the ceiling for deductible interest expense based on 30% of the E.B.I.T.D.A. of the group, as discussed below at **Domestic Consolidation**. The carryforward of nondeductible interest expense is also computed on a consolidated basis if Italian corporate income tax is computed on a consolidated basis in the arising year and the carryforward year.

In the past few years, the deductibility of interest incurred in connection with merger or leveraged buyout acquisitions has been challenged by the Italian tax authorities based on anti-abuse rules or the assertion that the expense is not connected with the activities of the target. In Circular Letter n. 6/E of March 30, 2016, the Italian Revenue Agency clarified that, as a general principle, interest expense incurred on acquisition financing may be deductible in the following circumstances:

- The acquisition debt is functionally connected to the leveraged acquisition.
- The leveraged transaction is not considered abusive. This means that, based on specific circumstances, the debt was not incurred to obtain a tax advantage that is contrary to the spirit and objectives of the law. An example of an abusive transaction is a re-leveraging transaction after completion of the acquisition in the absence of a change of control over the target.

## MINIMUM TAXABLE INCOME FOR NON-OPERATING COMPANIES

Specific anti-avoidance rules apply to non-operating companies and non-operating permanent establishments in Italy. Under Article 30 of the Law n. 724 dated December

<sup>18</sup> Specific grandfathering rules are provided with respect to deduction of interest of expense related to loans granted before June 17, 2016 (which are not subsequently modified).

<sup>19</sup> *Id.*, Article 96 (12).

23, 1994, 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:

- 2% of the total value of participations in resident and nonresident companies, bonds, other financial instruments, and financial credits
- 4% to 6% of the value of real estate and ships owned or leased by the company
- 15% of the value of other fixed assets

The calculation is made on the average values over a three-year period that includes the tax period concerned and the two preceding periods. Dividends are not considered as revenue and shareholdings in operating subsidiaries are excluded from the total value of participations.

When a company is a non-operating company under the foregoing definition, it is taxed at a rate of 34.5% on minimum income.<sup>20</sup> Minimum income is calculated by applying a deemed return to the assets mentioned above. The deemed returns are the following:

- 1.50% of participations, other financial instruments, and financial credits
- 4.75% of real estate values (reduced to a 3% to 4% rate for residential real estate assets and offices)
- 12% of other fixed assets.

A non-operating company may attempt to obtain an exemption from the minimum tax by demonstrating that specific facts and circumstances prevented it from achieving the minimum turnover and in a submission to the Italian tax authorities. 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.<sup>21</sup>

Certain automatic exclusions from the scope of the general rule exist if any of the following facts exist:

- The company is in the first year of activity.
- The shares of the company, its controlling shareholders, or one or more subsidiaries are traded on a stock exchange.
- The company had at least ten employees in the two preceding fiscal periods.
- The value of the company's production measured on the profit and loss statement is greater than the total value of assets reported on the balance sheet.
- The company is undergoing insolvency proceedings.

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<sup>20</sup> A surtax of 10.5% is applicable. See Article 2 (36-*quinquies*) of Decree Law n. 138 of August 13, 2011. Moreover, the V.A.T. credit related to a non-operating company cannot be refunded. In addition, if for three consecutive tax periods the non-operating company does not carry out any transaction that is relevant for V.A.T. purposes, the V.A.T. credit cannot be carried forward for offsetting V.A.T. payable relating to subsequent tax periods.

<sup>21</sup> See Article 30 (4-*quater*) of Law n. 724/1994, as modified by Article 7 of Legislative Decree n. 156 of September 24, 2015.



*“The non-operating company provisions are also applicable to companies under an alternative test. The alternative test looks at loss history of the company in two scenarios.”*

The non-operating company provisions are also applicable to companies under an alternative test. The alternative test looks at loss history of the company in two scenarios. The first is that the company has incurred tax losses for at least five consecutive tax years. The second is that the company has incurred tax losses for only four out of five tax years and in one year has reported income that is lower than the minimum income that typically triggers non-operating company status as set forth above. In either scenario, the company will be deemed to be a non-operating company effective at the beginning of the sixth year.

## ALLOWANCE FOR CORPORATE EQUITY<sup>22</sup>

In order to encourage companies to strengthen their financial structure by using equity rather than debt, Article 1 (287) of the Law dated December 30, 2019, n. 160 re-introduced the Allowance for Corporate Equity (“A.C.E.”) governed by Law Decree of December 6, 2011, n. 201. Under the A.C.E. regime, a notional return on the increase in equity generated after 2010 may be deducted from total net income if it is derived from capital contributions and the retention of earnings.<sup>23</sup> The amount of A.C.E. that exceeds the net taxable income of the year can be carried forward and used to offset the net taxable base of a subsequent tax period, or it can be converted into a tax credit equal to 24% of the notional yield to offset (in five equal annual installments) the I.R.A.P. due for each tax year.

Ministerial Decree of August 3, 2017, (hereinafter “the Decree”) which explicitly abrogated the former Decree of March 14, 2012,<sup>24</sup> contains the operative provisions for computing the A.C.E. deduction. The A.C.E. applies as of the tax year in which December 31, 2011, falls. The benefit may be claimed by each of the following business enterprises:

- Companies resident in Italy, as indicated by Article 73(1)(a) I.T.C.
- State and private entities other than companies, as well as trusts resident in Italy, whose main or exclusive objective is to carry out a commercial activity, as indicated by Article 73(1)(b) I.T.C.
- Italian permanent establishments of nonresident companies and entities, as indicated by Article 73(1)(d) I.T.C.
- Individuals, S.N.C.’s, and S.A.’s regulated by ordinary accounting rules.

The A.C.E. is determined by applying a given percentage rate to the net increase in equity, which in turn is calculated as the excess of the equity book value at the end of the year over the equity book value resulting from the balance sheet as of December 31, 2010.<sup>25</sup> From 2019, the rate is 1.3%.<sup>26</sup>

<sup>22</sup> A.C.E. has never been effectively eliminated. Article 1 (1080) of the Law dated December 30, 2018 n. 145 abolished A.C.E. starting from fiscal year 2019 and Law Decree of April 30, 2019, n. 34 introduced a similar tax incentive connected to undistributed profits of corporate entities (“Mini-I.R.E.S. regime”).

<sup>23</sup> See Article 1 (2) of Law Decree n. 201 of December 6, 2011, as modified by Article 7 (1) of Law Decree n. 50 of April 24, 2017.

<sup>24</sup> See Article 13 of the Decree.

<sup>25</sup> The equity book value at the end of the year 2010 is computed without taking into account the profit of the year 2010.

<sup>26</sup> See Article 1 (287) of Law n. 160 of December 27, 2019.



For fiscal year 2021, Article 19 of Law Decree of May 21, 2021, converted into Law n. 106 of July 23, 2021, states that the rate is increased up to 15% of the relevant capital increase carried out in 2021 over the equity book value resulting from the balance sheet as of December 31, 2020, up to the maximum amount of €5 million (hereinafter the “Super A.C.E.”). Moreover, the Super A.C.E. deduction can be converted – with prior notification to Italian tax authorities – into a tax credit equal to 24% of the notional yield and it can be used for offsetting other tax debit.<sup>27</sup> Otherwise, the tax credit could form the basis for a refund claim or transferred to third parties in return for cash or other consideration.<sup>28</sup>

In order to determine the net increase in equity, Article 5(2) of the Decree states that the following items must be taken into account:

- Cash contributions paid by existing or new shareholders.
- The shareholders’ unconditional relinquishment of an obligation of the company and the release of an obligation upon the underwriting of a new issue of shares.
- Income accumulated, with the exception of income accumulated in non-available reserves.<sup>29</sup>

The net increase in any particular year cannot exceed the value of the net equity at the end of that year.<sup>30</sup> Moreover, for entities other than banks and insurance companies, the net increase must be reduced by an amount equal to the increase in value of non-equity securities (including shares in undertakings for collective investments) compared to their value as of December 31, 2010.<sup>31</sup>

In computing the net increase in equity, Article 5 (4) of the Decree provides that decreases in equity through any type of distribution to a shareholder must be taken into account. This rule covers dividend distributions and equity reductions.

Specific rules are provided for companies participating in a group consolidation<sup>32</sup> and for companies opting for the “transparency regime” under Articles 115 and 116 I.T.C.<sup>33</sup> Moreover, Article 10 of the Decree provides specific anti-avoidance rules that are directed at companies belonging to a group.

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<sup>27</sup> Under the Provision of the Director of the Italian Revenue Agency dated September 17, 2021, the methods, terms of presentation, and the content of the communication for the use of the Super A.C.E. tax credit and the rules for the assignment of the credit are defined.

<sup>28</sup> Special recapture rules apply to capital decrease occurred in the subsequent years 2022 and 2023.

<sup>29</sup> See *id.*, Article 5(6) for the definition of “non-available reserves.”

<sup>30</sup> *Id.*, Article 11. Such limitation is not applicable to capital increases carried out in 2021 up to the maximum amount of €5 million, according to Article 19 of Law Decree of May 21, 2021.

<sup>31</sup> See Article 1 (6-*bis*) of Law Decree n. 201 of December 6, 2011, as modified by Article 1 (550) of Law n. 232 of December 11, 2016, and Article 5 (3) of the Decree.

<sup>32</sup> See Article 6 of the Decree.

<sup>33</sup> *Id.*, Article 7.

## GROUP CONSOLIDATION

After the introduction of the participation exemption regime, holding companies cannot reduce income through unrealized losses in participations. However, group consolidation is permitted. Two consolidation regimes exist. One is known as the domestic consolidation regime,<sup>34</sup> and the other is the international or worldwide consolidation regime.<sup>35</sup>

### Domestic Consolidation

For the purpose of the domestic consolidation regime, a group of companies includes a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two factors exist. First, the common parent must, directly or indirectly, have more than 50% of the voting rights at the subsidiary's general shareholders' meeting. Second, the common parent must, directly or indirectly, be entitled to more than 50% of the subsidiary's profits. The "de-multiplier effect" must be considered in both cases.

In certain circumstances, a nonresident company may participate in a domestic consolidation as the common parent of the group. First, the foreign parent must be a resident in a country that has a tax treaty in effect with Italy. Second, the foreign parent must carry out business activities in Italy through a permanent establishment. Legislative Decree n. 147 of September 14, 2015, introduced a "horizontal" tax consolidation regime. With effect from 2015, this regime allows a parent entity that is resident in an E.U. Member State or E.E.A. Member State that has signed an agreement with Italy allowing the effective exchange of information to designate an Italian-resident subsidiary or permanent establishment as a "consolidating" entity. The consolidating entity may then form a single fiscal unit with another direct or indirect subsidiary of the same parent company. Legislative Decree n. 147 also introduced legislation allowing Italian permanent establishments of E.U. and E.E.A. companies to be included in the fiscal unit as consolidated entities with other Italian-resident companies of the same group.

The domestic consolidation regime applies only when an election has been made by the common parent and the participating controlled subsidiaries. All subsidiaries are not required to participate in the regime. Once an election is made, the domestic consolidation is effective for three tax periods. If the requisite degree of control in a subsidiary is relinquished during this time, that subsidiary no longer participates.

The domestic consolidation regime works as follows. Each company determines its taxable income or loss on a separate company basis, according to the ordinary rules, and submits its own tax return without computing the relative income tax or credit. Then, the common parent aggregates the group's taxable income or loss and computes the consolidated income tax or credit. The total taxable income or loss of each controlled subsidiary is considered regardless of the percentage held by the common parent.

Domestic consolidated groups may take advantage of a rule that allows for a combined computation of E.B.I.T.D.A. and interest expense, which is applicable to the ceiling imposed on interest expense. See above at **Interest Deduction**. A separate

<sup>34</sup> See Article 117-129, I.T.C.

<sup>35</sup> *Id.*, Article 130-142.

limitation rule applies to losses incurred during a tax period in which a company did not participate in the consolidation regime. These losses are ring-fenced in that company and cannot be brought forward to reduce group income.

### **Worldwide Consolidation**

In addition to the domestic regime, Italian law allows for worldwide consolidation where an Italian-resident company controls one or more nonresident companies. In order for a nonresident company to participate, its financial statements must be audited. Companies that fulfill the conditions for the worldwide consolidation regime can apply for an optional ruling from the Italian tax authorities verifying that the requirements to opt for the worldwide consolidation regime are effectively met.<sup>36</sup>

Several differences exist between the domestic consolidation regime and the worldwide regime. First, the worldwide regime is not selective among group members. The option must be exercised by *all* of the nonresident controlled subsidiaries in order to be effective. In addition, the first election for worldwide consolidation is effective for five tax periods and any subsequent renewal is effective for three tax periods. It is believed that the option for worldwide consolidation has been exercised by only a few Italian groups of companies.

## **C.F.C. LEGISLATION<sup>37</sup>**

Profits realized by a C.F.C. are deemed to be the profits of an Italian company when all the following conditions are met:

- The resident company directly or indirectly controls the nonresident entity.
- At least one third of the revenue of the foreign company is passive income (as defined below).
- The foreign subsidiary is subject to an effective tax rate which is lower than 50% of the effective tax rate which would be applicable if the same entity were resident in Italy.<sup>38</sup>

For purposes of the C.F.C. regime, a company may be deemed to be controlled in either of the following circumstances:

- The Italian resident maintains control of the foreign company as defined in Article 2359 of the Italian Civil Code, by (i) holding, directly or indirectly, the majority of the voting rights exercised at the general shareholders' meeting of the company or sufficient votes to exert a decisive influence in the

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<sup>36</sup> *Id.*, Article 132 (3).

<sup>37</sup> *Id.*, Article 167, as recently modified by Article 4 of the A.T.A.D. (the main changes introduced by this provision are clarified in the Circular Letter n. 18/E, issued by the Italian Revenue Agency on December 27 2021; it provides detailed guidance regarding the scope of the C.F.C. rules, the control requirement, the level of taxation requirement, and the determination, allocation, and taxation of the C.F.C. income).

<sup>38</sup> The Provision of Director of the Italian Revenue Agency dated December 27, 2021, which replaced the previous Provision dated September 16, 2016, contains the criteria for determining the effective level of taxation of the C.F.C. with simplified procedures.

shareholders' meeting of the company or (ii) having a dominant influence over the company due to contractual relationships.

- The Italian resident holds more than 50% of the profit rights of the foreign company directly, indirectly or by one or more companies controlled according to Article 2359 of the Italian Civil Code.

In addition, the following enterprises are considered controlled for C.F.C. purposes:

- A foreign permanent establishment of a C.F.C.
- A foreign permanent establishment of a resident company which opted for the branch exemption regime that is discussed below at **Branch Exemption Regime**.

The following types of revenue are deemed to be passive income:

- Interest or any other income deriving from financial assets
- Royalties or any other income arising from intellectual property
- Dividends and income deriving from the disposal of shares
- Income from financial leasing
- Income derived from insurance, banking and other financial activities
- Revenues derived from sales of low-value goods and supply of low-value services, carried out with associated companies

In order to avoid the application of the C.F.C. regime, an Italian-resident company may request a ruling from the Italian tax authorities and provide evidence that the nonresident company carries out a substantial economic activity supported by staff, equipment, assets, and premises. From 2015, an advance ruling is no longer mandatory, provided that the taxpayer can prove during a tax audit that the conditions to avoid C.F.C. status have been met. Where an advance ruling has not been requested or a positive ruling was not obtained, the existence of C.F.C. subsidiaries must be disclosed on the 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 attributed *pro rata* by reference to the profit participation rights held by the Italian company that maintains control and are taxed separately at the average tax rate for Italian-resident corporations, which is 24%.

Italian law provides for the concept of previously taxed income. When profits that were previously attributed to an Italian resident company are distributed in the form of dividends, the dividends are not treated as taxable income.

## TREATY PROTECTION

Italy has income tax treaties in effect with over 90 jurisdictions, including many developed countries and significant trading partners. In general, the treaties provide for reduced withholding tax rates in line with the O.E.C.D. Model Treaty. A notable exception exists for withholding tax on interest. In the current treaty with the U.S., the withholding tax rate on interest income is 10%, which is problematic for many groups.



Listed below are the jurisdictions that have income tax treaties with Italy that are currently in force and effect:

Albania	Ethiopia	Malta	Slovakia
Algeria	Finland	Mauritius	Slovenia
Argentina	France	Mexico	South Africa
Armenia	Georgia	Moldova	South Korea
Australia	Germany	Mongolia	Spain
Austria	Ghana	Montenegro	Sri Lanka
Azerbaijan	Greece	Morocco	Sweden
Bangladesh	Hong Kong	Mozambique	Switzerland
Barbados	Hungary	Netherlands	Syria
Belarus	Iceland	New Zealand	Taiwan
Belgium	India	Malaysia	Tajikistan
Bosnia & Herzegovina	Indonesia	Norway	Tanzania
Brazil	Ireland	Oman	Thailand
Bulgaria	Israel	Pakistan	Trinidad & Tobago
Canada	Ivory Coast	Panama	Tunisia
Chile	Jamaica	Philippines	Turkey
China	Japan	Poland	Uganda
Colombia	Jordan	Portugal	Ukraine
Congo (Rep.)	Kazakhstan	Qatar	U.A.E.
Croatia	Kyrgyzstan	Romania	U.K.
Cyprus	Kuwait	Russia	U.S.A.
Czech Republic	Latvia	San Marino	Uruguay
Denmark	Lebanon	Saudi Arabia	Uzbekistan
Ecuador	Lithuania	Senegal	Venezuela
Egypt	Luxembourg	Serbia	Vietnam
Estonia	Macedonia	Singapore	Zambia

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

## WITHHOLDING TAXES ON OUTBOUND PAYMENTS

### **Dividend Withholding – Domestic Law**

In general, Italian domestic tax law provides that dividends distributed by Italian companies to nonresident persons are subject to a 26% withholding tax pursuant to Article 27 of Presidential Decree n. 600/1973. The recipient can claim a refund of up to eleven twenty-sixths of the withholding tax incurred when taxes have been paid on the same income in its country of residence.<sup>39</sup> This results in a net tax of 15% after receipt of the refund. Starting from 2021, dividend distributed to certain

<sup>39</sup>

See Article 27 (3) of Presidential Decree September 29, 1973 n. 600.

*“If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.”*

nonresident funds are not subject to withholding tax.<sup>40</sup> It does not matter whether the fund is compliant with Directive 2009/65/E.U. Rather, the key factor is that the fund is established in an E.U. Member State or E.E.A. Member State allowing for an adequate exchange of information for tax purposes and whose manager is subject to regulatory supervision in the country where it is established pursuant to Directive 2011/61/E.U. –Dividends paid out to pension funds established in E.U. or E.E.A. Member States listed in Ministerial Decree September 4, 1996 are subject to 11% withholding tax.<sup>41</sup>

If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.

For dividends distributed to companies or other entities resident and subject to income tax in E.U. or E.E.A. Member States included on the abovementioned list, a reduced 1.2% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions made to domestic companies as discussed above at **Dividend Exemption**. If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are entitled to a 95% exemption, as discussed above.

### **Parent-Subsidiary Directive**

Under the Parent-Subsidiary Directive (the “P.S.D.”) as implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may claim a refund for the 26% or 1.2% for withholding tax actually withheld on dividends distributed by Italian subsidiaries. After the amendments enacted by Directive

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See Article 1 (631-633) of Law n. 178 of December 30, 2020, which modified the above-mentioned Article 27 of Presidential Decree September 29, 1973 n. 600. The amendment has been introduced in order to eliminate a discrimination between Italian and foreign investment funds. Since the scope of Article 63 T.F.E.U. on the free movement of capital extends also to third Countries, in order to fully comply with E.U. law, exemption from taxation at source should be eliminated also in respect of dividend received by non-E.U. investment funds provided that the relevant management company is subject to supervision and the fund is established in country which allows an adequate exchange of information with Italy so that the Italian tax authorities are able to verify that the fund is subject to a prudential supervision similar to that provided for by E.U. law under A.I.F.M.D. In this regard, the European Court of Justice stated that the principle of free movement of capital pursuant to Article 63 of the T.F.U.E.

must be interpreted as precluding a Member State’s legislation under which dividends distributed by resident companies to a non-resident collective investment undertaking (U.C.I.) are subject to a withholding tax, while dividends distributed to a resident U.C.I. are exempt from such withholding tax

regardless of whether the recipient of the dividend is an E.U. or non-E.U. U.C.I. (see the decision relating to case C-545/19 dated March 17, 2022).

Even though the new provisions are effective in respect to dividends paid from January 1, 2021, in case of conflict, based on the supremacy of E.U. law over national law, Member States should eliminate domestic provisions which infringe on E.U. law retrospectively (therefore, the new provisions should also be extended to dividends paid before 2021; see in this respect the decision n. 49 of the Provincial Tax Court of Pescara, dated February 7, 2022).

<sup>41</sup>

Iceland, Liechtenstein, and Norway.

2003/123/C.E.,<sup>42</sup> the required minimum for direct shareholding in the Italian company is reduced to 10%.

In order for a company to qualify as a parent for the benefit of the P.S.D., certain requirements must be met:

- The parent company must have one of the corporate forms listed in the P.S.D.
- The parent company must reside for tax purposes in an E.U. Member State.<sup>43</sup> For this purpose, a dual resident company is not considered to be a resident of an E.U. Member State if its residence is allocated to a jurisdiction outside the E.U. under an income tax treaty.
- The parent company must be subject to one of the income tax regimes listed in the P.S.D. without the possibility of opting for favorable regimes or exemptions.
- The parent must have held the participation for an uninterrupted period of at least one year.

To demonstrate compliance with the first three conditions, a certificate issued by a foreign tax authority must be submitted. The last condition is corroborated by a declaration. Once the foregoing conditions have been met, the exemption is mandatory.

The general anti-abuse rule (“G.A.A.R.”) applies when determining if a parent company is entitled to the P.S.D. An E.U. parent may not benefit from an exemption arising from holdings that are shown to be artificial or that have been established with the sole or primary purpose of taking advantage of the exemption.<sup>44</sup>

As clarified in Circular Letter n. 6/E of March 30, 2016, related to leveraged buy-out transactions, with reference to G.A.A.R., an intermediate entity is deemed to have been set up merely as a conduit entity or as a part of a conduit arrangement in either of the following fact patterns apply to the intermediary:

- The intermediary entity has a light organization and does not carry out real economic activity or has little or no discretion in the decision-making process so that it may be viewed to be a conduit entity. A light organization exists where employees, offices, and equipment of the intermediary are made available by third-party service providers through management service agreements.
- The intermediary entity acts merely as a financial conduit in the context of a specific arrangement such as inbound and outbound payments that are symmetrical in term of amount, and maturity. In this way, the function of the intermediary entity allows payments to flow through without incurring an additional tax burden because payments made by the intermediary entity are not subject to further withholding tax. It thus serves as a conduit arrangement.<sup>45</sup>

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<sup>42</sup> Implemented in Italy by Legislative Decree dated February 6, 2007, n. 49. Article 27-*bis* of Presidential Decree n. 600/1973.

<sup>43</sup> Following the U.K.’s exit from E.U., starting from 2021 U.K. companies will no longer benefit from Parent-Subsidiary Directive.

<sup>44</sup> See the last paragraph of Article 27-*bis* of Presidential Decree n. 600/1973.

<sup>45</sup> See Circular Letter n. 6/E, issued by the Italian Revenue Agency on March 30, 2016.

## **Interest and Royalties**

### **In General**

Italy has implemented the Interest and Royalties Directive (“I.R.D.”) providing for a withholding exemption on payments of interest and royalties made to associated companies resident in E.U. Member States.<sup>46</sup> In order to qualify for the exemption, the recipient must be an associated company resident in another Member State that (a) is subject to one of the taxes listed in the P.S.D. Annex B, and (b) has one of the corporate forms listed in the P.S.D. Annex A. Alternatively, the recipient can be a permanent establishment of a company resident in a Member State, granted the permanent establishment is also situated in a Member State. In all instances where benefits of the I.R.D. are claimed, the nonresident recipient must be the beneficial owner of the payments.<sup>47</sup>

For the purposes of the I.R.D., two companies are deemed to be associated under one of two tests.

- The first test is that one of the companies directly holds 25% or more of the voting rights at the general shareholders’ meeting of the other company. It does not matter which of the payor or recipient holds the requisite shares of the other company.
- The second test is that a third company, resident in a Member State and having one of the corporate forms listed in P.S.D. Annex A, directly holds 25% or more of the voting rights in the payor and the recipient companies.

No matter which test is applicable, the requisite ownership must be held for at least one year as of the date of the payment.

### **Intra-Group Interest Payments in the Context of Group-Issued Bonds**

Article 23 (1) of Law Decree n. 98 of July 6, 2011, introduced a new 5% withholding tax applicable to interest paid to a nonresident that is not the beneficial owner of the payments when all the following conditions are met:

- The recipient is subject to one of the taxes listed in the P.S.D. and has one of the listed corporate form, as previously described.
- The interest payment is intended to finance the payment of interest and other proceeds on bonds issued by the recipient.
- The bonds are traded on an E.U.- or E.E.A.-regulated market.
- The bonds are guaranteed by the company paying the interest, its holding company, or a subsidiary.<sup>48</sup>

<sup>46</sup> See Article 26-*quater*, Presidential Decree n. 600/1973. Following the U.K.’s exit from E.U., U.K. companies will no longer benefit from the I.R.D.

<sup>47</sup> For the definition of “beneficial owner” see *id.*, Article 26-*quater* (4).

<sup>48</sup> For more details, see *id.*, Article 26-*quater* (8-*bis*).





### Danish Cases

In the so-called Danish Cases, the European Court of Justice (“E.C.J.”) issued its judgments in joined cases C-115/16, C-118/16, C-119/16 and C-299/16 and in joined cases C-116/16 and C-117/16, respectively concerning the Interest and Royalty Directive and the P.S.D. The question submitted to the E.C.J. was whether dividend and interest payments were exempt from withholding tax when the payment was made to an E.U. company that subsequently passed the income to an ultimate parent company resident in a third country outside the E.U.

The E.C.J. first stated that based on the general principle of E.U. law, that E.U. law cannot be relied on for abusive or fraudulent ends. Exemption from withholding will be denied if the transaction has been put in place with the essential aim of benefiting from tax advantages, even if that is not the exclusive aim.

The E.C.J. went on to provide guidance to be used when assessing the existence of abuse in case of intermediary holding companies. Under that guidance, an arrangement may be considered as artificial when:

- Very soon after their receipt of dividends, the recipient passes all or almost all of the dividends to entities that do not fulfill the conditions for the application of the P.S.D. or the I.R.D. In this respect it is not necessary for the receiving company to have a contractual or legal obligation to pass the dividends, interest, or royalties to a third party. It may be sufficient to demonstrate based on the factual circumstances that the company does not have the right to enjoy the income received because *de facto* it acts as a conduit company.
- The intermediary company makes only an insignificant taxable profit, considering it must transfer the dividend, interest, or royalties to another company.
- The intermediate holding company lacks economic substance and carries out very limited activities. In the opinion of the E.C.J.:

[The] absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has.

In order to establish the existence of an abuse, the indicia referred above must be objective and consistent. Therefore, it could be argued that a single element, on a stand-alone basis, should not be sufficient to demonstrate the abusive character of the operation. However, the E.C.J. further stated that when the beneficial owner of dividends, interest, or royalties paid is resident for tax purposes in a third state, exemption may be refused regardless of the existence of an abusive practice.

### Withholding Tax on Medium-Long Term Loans

Pursuant to Article 26 (5) of Presidential Decree 600/1973, interest payments made to lenders not resident in Italy are subject to a final withholding tax at a rate of 26%. Double taxation treaties in force between Italy and the lender’s country of residence may apply, allowing for a lower withholding tax rate (generally 10%), subject to

compliance with relevant subjective and procedural requirements. Nonetheless, according to paragraph 5-*bis*<sup>49</sup> of the same Article, final withholding tax does not apply to interest payments on medium-long term loans<sup>50</sup> granted to commercial entities by any of the following entities:

- Credit institutions established in E.U. Member States
- Insurance companies incorporated and authorized under the law of E.U. Member State
- Foreign institutional investors, regardless their tax status, established in Whitelisted jurisdictions and subject to regulatory supervision therein
- Certain non-banking, state-owned entities such as the U.K. National Savings Bank

The abovementioned exemption is available only when the laws governing lending activities to the public are not infringed. Therefore, to benefit from the exemption, the lender must comply with all of the regulatory requirements for lending to the public.

In case facilities are partially or totally funded by back-to-back or other similar risk sharing agreements entered into between the fronting lender and the participants, payment of interest under the facilities will be subject to withholding tax depending on the status of the participant that is the beneficial owner of a particular interest in the loan, while the fronting lender will be disregarded, save for that part of the financing which has been funded by the fronting lender with its own financial resources.<sup>51</sup> Consequently, the borrower will make interest payments without tax deduction to the extent that the relevant participant meets and properly communicates the conditions requested to benefit from the withholding tax exemption pursuant to Article 26(5-*bis*) Presidential Decree 600/1973 and that the participant complies with the regulatory provisions on reserved banking or lending activities.

<sup>49</sup> Introduced by Article 22 (1) of Law Decree n. 91 of June 24, 2014.

<sup>50</sup> Medium-long term loans are loans that (i) have a contractual duration of more than 18 months and one day and (ii) do not provide a prepayment option.

<sup>51</sup> Such reasoning, according to which Article 26 (5-*bis*) of Presidential Decree n. 600/1973 should apply based on the identity of the ultimate beneficial owner of the interest, has been partially contradicted by the Italian tax authority in Ruling Answer n. 423 of 23 October 2019 and Ruling Answer n. 125 of 24 February 2021 (as well as in another unofficial ruling) where it was stated that an exemption cannot be extended to the beneficial owner of the interest that is not the direct “recipient” of the interest. In particular, the Italian tax authority denied exemption on interest paid to a non-E.U. associated company although the loan granted by the associated company was financed through a back-to-back loan granted by an E.U. bank and therefore interest paid by the Italian borrower was indirectly received by an entity falling within the scope of Article 26 (5-*bis*) of Presidential Decree n. 600/1973. However, one opinion is that such clarification cannot be interpreted in the sense that the exemption applies irrespective of the identity of the beneficial owner of the interest (in this respect, please consider that in the abovementioned Ruling Answer No. 125, the Italian tax authorities stated that Article 26(5-*bis*) of Decree N. 600/1973 cannot apply if the beneficial owner of interest does not “also” qualify as the relevant direct recipient). Indeed, if interest paid to a lender which qualifies for exemption under Article 26 (5-*bis*) of Decree N. 600/1973 are passed to a sub-participant which does not qualify for the exemption, the structure could be challenged based on the anti-abuse principle.

In a criminal case (Case n. 12777/2019), the Italian Supreme Court addressed a fact pattern in which a fronting Italian licensed bank granted loans to Italian customers using the funds made available by a foreign bank based on an undisclosed mandate. The Supreme Court held there to be a breach of the regulatory prohibition of financial operations in the absence of authorization. Based on the court reasoning, even though the financing relationship was structured based on two separate contracts, for the purpose of the regulatory restrictions on lending, the concrete substance of the transaction prevailed over the legal form. In reaching that conclusion, the court adopted a list of criteria that should be considered when determining if the financing was actually granted by the foreign bank and that the legal structure hid the real activity carried out by the foreign non-licensed bank. The list of criteria is as follows:

- The sharing of the insolvency risk between the fronting lender and the foreign bank
- The independent assessment of customers' credit standing by the foreign bank
- The acknowledgment by the customers of the involvement of the foreign bank by signing the inter-creditor agreement with the latter
- The right of the foreign bank to be informed and to approve all circumstances that may affect the borrower's credit rating
- The fact that the commitment of the foreign bank exceeds the commitment of the fronting lender
- The fact that the fronting bank reported to the Italian Central Risk Data Base only its own exposure and not the overall amount of the loan

The court also observed that from a purely legal point of view, the undisclosed mandate provided the principal with some rights of action against the customers of the fronting institution, thus confirming that in substance the principal was the real lender.<sup>52</sup> In sum, the fronting institution acted more as an agent than a principal in the way it interfaced with borrowers and the regulatory agencies. The sub-participant that was not allowed to conduct direct lending activities in Italy could not benefit from exemption under Article 26(5-*bis*) Presidential Decree 600/1973.

### **Shell Entities**

On December 22, 2021, the European Commission issued a directive proposal aimed at ensuring that undertakings lacking minimal substance are not used as instruments of tax evasion or tax avoidance (hereinafter, the "Directive Proposal").

In general terms, the Directive Proposal provides indicators of minimum substance for undertakings in Member States and sets rules regarding the tax treatment of those entities that do not meet the indicators.

Undertakings that are presumed to be shell entities have the opportunity to rebut the presumption by demonstrating that they have substance or, in any case, that they are not misused for tax purposes. This is achieved by providing factual evidence of

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<sup>52</sup> The intercreditor agreement provided the principal with rights of direct action against the customers.

their activities and the manner in which they carry them out. An undertaking that is presumed to be a shell entity would not be able to access tax relief and benefits of the tax treaty network of its Member State and/or to qualify for the treatment under the E.U. Directives, such as the P.S.D. and the I.R.D. (see **Parent-Subsidiary Directive** and **Interest and Royalties** above).

The Directive Proposal provides for an automatic exchange of information on all entities within the scope of the Directive Proposal, regardless of whether these are shell entities or not. Moreover, the Directive Proposal enables Member States to request that another Member State conduct a tax audit if they have doubts on whether or not an entity has a minimal substance. The Member State receiving such a request is expected to perform the tax audit and communicate the outcome to the former Member State in a reasonable time frame.

The Directive Proposal, once adopted as a Directive, should be transposed into Member States' national law by June 30, 2023 and come into effect as of January 1, 2024.

### **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 discussed above in **Dividend Exemption** and **Participation Exemption for Gains**.

Pursuant to Article 152(2) I.T.C., replaced by Article 7(3) of Legislative Decree n. 147 of September 14, 2015 (the "International Tax Decree"), Italy applies the O.E.C.D.'s functionally separate entity approach when determining permanent establishment income. According to this methodology, income attributed to the permanent establishment will reflect an arm's length amount, *i.e.*, the amount the permanent establishment would have earned if it were a separate and independent enterprise engaged in comparable activities under comparable conditions. This arm's length amount should account for the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment.

Article 152(2) also provides that adequate free capital must be attributed to the permanent establishment for tax purposes. Again, the amount is determined based on O.E.C.D. principles, by considering the functions performed, assets used, and risks assumed by the permanent establishment.

### **Nonresident Company with No Permanent Establishment**

Nonresident companies without a permanent establishment in Italy are taxed on income generated in Italy under the rules applicable to resident individuals.<sup>53</sup>

Due to the changes introduced by the Budget Law for 2018,<sup>54</sup> as of January 1, 2019,<sup>55</sup> capital gains realized by foreign corporations upon the disposal of an interest in an



<sup>53</sup> See Article 151 (3), I.T.C.

<sup>54</sup> See Article 1 (999) of Law n. 205 of December 27, 2017.

<sup>55</sup> *Id.*, Article 1 (1005).

Italian subsidiary are subject to a 26% substitute tax<sup>56</sup> regardless of the size of the participation.

If the participation is not qualified and the disposition relates to a participation in a listed company, capital gains are deemed to have been generated outside of Italy.<sup>57</sup> If the participation is not qualified and the disposition relates to a participation in a private company, capital gains are not taxed if the shareholder is resident in a country that has an agreement allowing for an adequate exchange of information with Italy.<sup>58</sup>

A participation in a listed company is deemed to be qualified if the total interest sold during a 12-month period is greater than 2% of the company's voting rights or 5% of the capital of the listed company. If the company is not listed, a participation is qualified if the total interest sold during a 12-month period is greater than 20% of the company's voting rights or 25% of the capital of the company.

These rules are subject to modification under an applicable treaty.

## BRANCH EXEMPTION REGIME

The International Tax Decree introduced the branch exemption regime.<sup>59</sup> As of 2016, an Italian resident company may be exempt from Italian tax on income and losses arising from foreign permanent establishments.

The election of exempt treatment is irrevocable and all-in/all out – it is applicable to all or none of the qualified existing permanent establishments. Branches falling within the scope of the C.F.C. rules will not qualify unless the condition for C.F.C. exemption is met, as discussed above at **C.F.C. Legislation**.

A loss recapture provision applies if the branch has incurred a net tax loss over the five-year period prior to the election. In this case, branch income will be included in the taxable basis of the Italian parent company, up to the amount of the pre-existing tax losses, with a corresponding foreign tax credit.

## FOREIGN TAX CREDIT

A foreign tax credit is granted to avoid international double taxation.<sup>60</sup> The tax credit limitation is calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period.<sup>61</sup>

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<sup>56</sup> See Article 5 (2) of Legislative Decree n. 461 of November 21, 1997.

<sup>57</sup> See Article 23 (1) (f) I.T.C.

<sup>58</sup> See Article 5 (5) (a), Legislative Decree n. 461/1997.

<sup>59</sup> See new Article 168-*ter* I.T.C., introduced by Article 14 of Legislative Decree n. 147/2015.

<sup>60</sup> See Article 165, I.T.C.

<sup>61</sup> *Id.*, Article 165 (6).

## TRANSFER PRICING

The Italian transfer pricing regime appears in Article 110 (7) I.T.C. and Ministerial Decree of May 14, 2018. The guidelines for the application of these provisions reflect the latest developments as outlined in the B.E.P.S. Report on Action Items 8, 9 and 10.

*“The guidelines for the application of these provisions reflect the latest developments as outlined in the B.E.P.S. Report on Action Items 8, 9 and 10.”*

Pursuant to Article 110 (7),<sup>62</sup> business income of an Italian-resident enterprise is assessed on the basis of conditions and prices that would be agreed upon by independent parties operating at arm’s length conditions and in comparable circumstances when the transaction involves (i) a nonresident company<sup>63</sup> that is directly or indirectly controlled by the Italian enterprise, (ii) a nonresident company that controls the Italian company, or (iii) a resident company and a nonresident company that are under the common control of a third company.

Following certain amendments,<sup>64</sup> Article 110 (7) no longer refers to the normal value of goods and services as defined in Article 9 (3) I.T.C. as a criterion for determining intercompany transfer prices. It now refers instead to the arm’s length value, which can be compared to the arm’s length value as defined by the O.E.C.D. Transfer Pricing Guidelines<sup>65</sup> and the O.E.C.D. Model Convention.

Article 110 (7) as revised further states that the application of the arm’s length principle” applies in the case of both upward and downward adjustments in taxable income. Downward adjustments in taxable income may result from any of the following:

- Binding agreements concluded with the competent authorities of a Contracting State pursuant to a mutual agreement procedure provided for by a double tax treaty or E.U. Directive 90/436 (the “Arbitration Convention”)
- The completion of tax audits carried out in accordance with the Convention on Mutual Administrative Assistance in Tax Matters
- Rulings for a downward adjustment in an intercompany transfer price requested by an Italian taxpayer after the tax authorities of a country having in effect an income tax treaty with Italy (“Contracting State”) proposed a downward adjustment in the transfer price charged by an Italian company to an affiliate resident in the Contracting State. The relevant income tax treaty must contain provisions for exchanges of information and mutual agreement procedures in cross border transfer pricing matters. In this fact pattern, the taxpayer has a right to request a resolution to doubled taxation under the mutual agreement procedure of the applicable income tax treaty or the Arbitration Convention remain unchanged<sup>66</sup>

<sup>62</sup> As amended by Article 59 of Law Decree n. 50 of April 24, 2017.

<sup>63</sup> In this regard, Article 5 (2) of Legislative Decree n. 147/2015 clarifies that the arm’s length rule is not applicable to transactions between resident enterprises.

<sup>64</sup> See Article 59 of Law Decree n. 50 of April 24, 2017.

<sup>65</sup> As approved by the O.E.C.D. Council on July 10, 2017 and updated by the Transfer Pricing Guidelines dated January 20, 2022.

<sup>66</sup> In this respect, it should be noted that Legislative Decree n. 49 of June 10, 2020 recently implemented the Council Directive (E.U.) 2017/1852 on tax dispute resolution mechanism also provided for transfer pricing purposes.

Legislative Decree 78 of May 31, 2010, introduced Italian regulations for intercompany transfer pricing documentation. Although such documentation is not mandatory, this decree waives the application of administrative penalties if the taxpayer provides the relevant transfer pricing documentation to the tax authorities during a tax audit. Without the waiver, the penalties range from 90% to 180% of the tax assessed.

On November 23, 2020, the Italian tax authority introduced new provisions for intercompany transfer pricing documentation<sup>67</sup> with the aim of aligning the Italian transfer pricing regime to the international guidance provided by the O.E.C.D.<sup>68</sup>

Over the past few years, the Italian tax authorities have paid increasing attention to intra-group transactions during tax audits, resulting in an increase in the number of audits of intra-group transactions between members of multinational groups.

## NEW PATENT BOX REGIME

Article 6 of Law Decree n. 146 of October 21, 2021<sup>69</sup> replaced the Patent Box regime introduced by Article 1 of Law n. 190 of December 23, 2014<sup>70</sup> with a new optional regime consisting of the super-deduction of 110% of costs incurred for R&D activities (development, enhancement, maintenance, protection, and exploitation) in relation to copyrighted software, patents, designs, and models.<sup>71</sup> Compared with the previous Patent Box regime, trademarks and know-how have been excluded from the list of eligible assets.

The new Patent Box regime requires an irrevocable option of five years (with the possibility to renew) to be made in the tax return related to the fiscal year in which the Patent Box regime applies.

The Law Decree waives the application of administrative penalties if the taxpayer provides the relevant explanatory documentation regarding qualifying R&D activities performed and expenses incurred. Such documentation must be digitally signed within the date of presentation of the tax return.

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<sup>67</sup> See the Provision issued by the Director of the Italian Revenue Agency, of November 23, 2020, which substituted the previous Provision of September 29, 2010, and the Circular Letter n. 15/E, issued by the Italian Revenue Agency on November 26, 2021.

<sup>68</sup> O.E.C.D. Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, of July 10, 2017 updated by the Transfer Pricing Guidelines dated January 20, 2022.

<sup>69</sup> Converted into Law December 17, 2021, n. 215, as subsequently amended by Law December 30, 2021 n. 234.

<sup>70</sup> The “old” Patent Box regime granted a 50% exemption from I.R.E.S. and I.R.A.P. on income derived from the direct exploitation of certain intangible assets, such as patents, copyright protected software, and other intellectual property (“I.P. assets”) by resident companies and individual entrepreneurs or residents of treaty countries having an adequate exchange of information.

<sup>71</sup> The implementation rules for the new Patent Box regime are contained in the Provision of the Director of the Italian Revenue Agency dated February 15, 2022.

The new Patent Box regime is applicable as of fiscal year 2021. Taxpayers who opted for the previous Patent Box regime may continue to benefit from the old regime until the natural expiration of its five-year term.

## AUTOMATIC EXCHANGE OF INFORMATION

Italy supports the Automatic Exchange of Information (“A.E.O.I.”) for tax purposes and is actively involved in implementing A.E.O.I. within the E.U. and O.E.C.D., and on a bilateral basis.

On January 10, 2014, the U.S. and Italy signed an intergovernmental agreement (“I.G.A.”) to implement the Foreign Account Tax Compliance Act (“F.A.T.C.A.”) regime. The I.G.A. was then ratified and enacted in Italy by Law n. 95 of June 18, 2015. Ministerial Decree of August 6, 2015 and the Provisions of the Director of the Italian Revenue Agency dated August 7, 2015, and April 28, 2016, provided the technical rules for the collection and the communication of the requested information.

In accordance with the F.A.T.C.A. rules, the Italian legislation provides, in brief, for A.E.O.I. as follows:

- Italy will engage in bilateral exchanges of information with the U.S. in relation to accounts held in Italian financial institutions by U.S. persons.
- Financial institutions must forward specified information to the Italian tax authorities, which will transmit the data to the I.R.S.
- If certain conditions are met, holding companies may be subject to the F.A.T.C.A. reporting regime.

Similar reporting requirements have recently been introduced for countries other than U.S. The Common Reporting Standard (“C.R.S.”) and Directive 2014/107/E.U.<sup>72</sup> (“D.A.C.2”), regarding A.E.O.I. between tax authorities, are applicable in Italy. These rules were implemented in Italy by Law n. 95 of June 18, 2015, and enacted by Ministerial Decree dated December 28, 2015.<sup>73</sup>

Italian implementation of F.A.T.C.A., C.R.S., and D.A.C.2 is intended to prevent tax evasion by foreign individuals who maintain financial relationships with Italian financial institutions. In particular, these regulations require Italian financial institutions to identify their customers in accordance with specific criteria and to communicate certain information to relevant tax authorities abroad regarding (i) interest income, dividend income, and similar types of income, (ii) account balances, and (iii) sales proceeds from financial assets.

Although the deadline for transposition of Directive 2018/822/E.U. (“D.A.C. 6”) was December 31, 2019, D.A.C.6 was implemented in Italy by Legislative Decree n. 100 of July 30, 2020.

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<sup>72</sup> For exchanges between E.U. Member States, the E.U. has implemented the C.R.S. through D.A.C.2., with a starting date that has been deferred by three months to December 31, 2020.

<sup>73</sup> The Ministerial Decree dated May 4, 2022 replaced Annex C (containing the list of reporting jurisdictions) and Annex D (containing the list of participating jurisdictions) of the Ministerial Decree dated December 28, 2015.



***“Intermediaries, and in instances, taxpayers must provide notice of cross-border reportable arrangements to the Member State’s tax authorities.”***

On November 17, 2020, a Ministerial Decree was published implementing rules for the automatic exchange of information on reportable cross-border arrangements. In addition, on November 26, 2020, Italian tax authorities published the practical requirements for D.A.C.6 reporting purposes.

According to D.A.C.6, an arrangement is deemed reportable if it contains at least one hallmark (*i.e.*, a list of the features and elements of transactions that present a strong indication of tax avoidance or abuse), and in respect of certain hallmarks, where the “Main Benefit Test” is met (that test will be satisfied if it can be established that the main benefit a person may reasonably expect to derive from an arrangement is the expected tax advantage).

Intermediaries, and in instances, taxpayers must provide notice of cross-border reportable arrangements to the Member State’s tax authorities. Cross-border arrangements must be reported within 30 days beginning on the day after whichever of the following list is earliest:

- The arrangement is made available for implementation,
- The arrangement is ready for implementation, or
- The first step in its implementation has been taken.

Intermediaries and relevant taxpayers must file information on reportable cross-border arrangements, the first step of which was implemented between May 25, 2018 and June 30, 2020 (“historical cross-border arrangements”). Initially, the reports were due by August 31, 2020. However, the adoption of Directive 2020/876/E.U., deferred D.A.C.6 reporting deadlines by up to six months. Italy opted to defer the reporting deadlines as follows:

- The date for the beginning of the 30-day period for reporting cross-border arrangements is to be deferred from July 1, 2020 to January 1, 2021.<sup>74</sup>
- The date for reporting historical cross-border arrangements that became reportable between June 25, 2018 to June 30, 2020 is to be deferred from August 31, 2020 to February 28, 2021.
- The date for the first exchange of information on reportable cross-border arrangements is to be deferred from October 31, 2020 to April 30, 2021.

## ITALIAN MEASURES TO COMBAT B.E.P.S.

Fifteen specific actions have been or are being developed in the context of the O.E.C.D./G-20 project to combat base erosion and profit shifting (the “B.E.P.S. Project”). In substance, these actions cover all the principal aspects of international taxation – as they relate to C.F.C. rules, interest deductibility, artificial avoidance of

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As clarified by Italian tax authority in the Circular letter n. 2/E dated February 10, 2021, no penalties apply to late communications, provided that they are submitted by February 28, 2021. See also the Circular Letter n. 12/E, issued by the Italian Revenue Agency on May 13, 2022.

permanent establishment status, transfer pricing rules, curbing harmful tax practices, data collection, mandatory disclosure rules, and dispute resolution.<sup>75</sup>

Italy is compliant regarding most of the B.E.P.S. actions:

- As recommended by Action Item 13, Italy has introduced Country-by-Country Reporting obligations into domestic law. See Article 1(145-147) 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 as described above in **New Patent Box Regime**. Provisions excluding trademarks from Patent Box eligibility were introduced to align the Italian Patent Box regime with O.E.C.D. Guidelines.
- In order to promote tax transparency and disclosure initiatives under Action Items 5 and 11, a voluntary disclosure procedure has been introduced in Italy. In furtherance of this procedure and O.E.C.D. recommendations, the Italian government signed agreements regarding the exchange of information with Andorra, Barbados, the Cayman Islands, Chile, Cook Islands, Gibraltar, Guernsey, Hong Kong, the Isle of Man, Jersey, Liechtenstein, Luxembourg, Monaco, San Marino, Switzerland, Taiwan, and Vatican City.<sup>76</sup>
- Following the guidelines set out in B.E.P.S. Action 7, the domestic definition of the term “permanent establishment” was modified by Article 1 (1010) of Budget Law 2018. In particular, it contained amendments providing new rules for the prevention of artificial avoidance of permanent establishment status through specific activity exemptions, clarifying that activities that fall under the “negative list” must have a preparatory and auxiliary character in order to qualify.<sup>77</sup> New rules have also been introduced to prevent the artificial avoidance of permanent establishment status through *commissionaire* arrangements.<sup>78</sup> An anti-fragmentation rule<sup>79</sup> and a new definition of “close-ly-related person” were also introduced.<sup>80</sup>
- In respect to B.E.P.S. Action 1 addressing the tax challenges raised by digitalization, Italy unilaterally introduced a tax on digital services, as mentioned above at **Corporate Tax Rate**. This tax will be repealed upon the entry into force of internationally agreed measures on the taxation of the digital economy.
- In compliance with B.E.P.S. Action 12 related to mandatory disclosure rules, Italy has implemented D.A.C.6 on the automatic exchange of information in

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<sup>75</sup> For a list of all B.E.P.S. Actions, see Chapter 3 of this text, “B.E.P.S. and Holding Companies.”

<sup>76</sup> The above-mentioned Ministerial Decree dated May 4, 2022 replacing the Annex C of the Ministerial Decree dated December 28, 2015 further extended the list of the reporting jurisdictions.

<sup>77</sup> Article 162 (4-4-bis) I.T.C.

<sup>78</sup> *Id.*, Article 162 (6-7).

<sup>79</sup> *Id.*, Article 162 (5).

<sup>80</sup> *Id.*, Article 162 (7-bis).

the field of taxation in relation to reportable cross-border arrangements, as discussed above at **Automatic Exchange of Information**.

- Pursuant to Article 1 (1101) of Law n. 178 of December 30, 2020, Article 31-ter of Presidential Decree 600/1997 has been modified in compliance with B.E.P.S. Action 14, which states that countries with bilateral A.P.A. programs should provide for the rollback of A.P.A.'s. Based on the provision, an A.P.A. may apply retrospectively up to the tax year in which the request was submitted, provided that (i) the A.P.A. is based on agreement reached among Competent Authorities pursuant to the relevant income tax treaty, (ii) the facts and the circumstances underlying the A.P.A. were the same also in previous tax periods, and (iii) the taxpayer expressly requests that the A.P.A. will be applied retrospectively and submits amended tax returns.

Many of the new tax rules provided by the International Tax Decree and the A.T.A.D. Decree are closely linked to the B.E.P.S. Project reports released in 2014 and 2015,<sup>81</sup> including:

- The modification of advance ruling procedures for international companies related to (i) transfer pricing operations, (ii) the existence of a permanent establishment, and (iii) the attribution of profits to a permanent establishment, in order to provide for the spontaneous exchange of information by the Italian tax authorities (see new Article 5 (1-bis) of Legislative Decree n. 29 of March 4, 2014, introduced by Article 1 (2) of Legislative Decree n. 32 of March 15, 2017).
- The (i) adoption of an effectively connected income concept for permanent establishments, repealing the so-called force of attraction rules that provided for the taxation of certain income produced in Italy but not effectively linked to the permanent establishment and (ii) introduction of the branch exemption regime, discussed above at **Branch Exemption Regime**.
- The reform of the interest deduction rules in order to discourage artificial debt arrangements designed to minimize taxes, as discussed above in **Interest Deduction** and the revision of the C.F.C. rules in order to deter profit shifting to low-tax or no-tax countries, as discussed above in **C.F.C. Legislation**. In consideration of the close connection between the C.F.C. regulation and the tax treatment of dividends and capital gains, the tax regime of profit distributions and capital gains and losses arising from sales of investments in nonresident companies were modified as discussed above at **Dividend Exemption** and **Participation Exemption for Gains**.
- The modification of the regime for outbound and inbound transfers of company tax residence to prevent companies from avoiding tax when relocating assets, as provided in Article 166 and 166-bis, respectively, of I.T.C.

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<sup>81</sup> Other tax measures provided by the International Tax Decree, such as the new rules regarding domestic tax consolidation, which extend the option to apply the Italian consolidation regime to sister companies (including permanent establishments) that are controlled by the same foreign company resident in an E.U. Member State or E.E.A. Member State, allowing adequate exchange of information, are intended to comply with rulings of the E.C.J. “*SCA Group Holding and Others*,” Joined Cases C-39-41/13, delivered June 12, 2014, discussed above at Paragraph H.i of this Chapter.

- The introduction of specific rules to neutralize the effects of hybrid mismatch arrangements aimed at preventing double deduction arrangements and deduction without income inclusion arrangements. Consequently, to the extent that a hybrid mismatch results in a double deduction no deduction is allowed in Italy. Where the Italian entity is the payer of the hybrid payment, the deduction is not allowed where the recipient of the hybrid payment and the maker of a related payment is resident in another jurisdiction and claims a deduction for the payment without taking the associated receipt into income.
- Other rules are introduced with reference to the case hybrid mismatches resulting from a deduction without inclusion, implementing Article 9 (2) of the A.T.A.D., which provides that to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer will deny the claimed deduction for the payment. Moreover, specific rules are provided with reference to the case of reverse hybrids and dual residence mismatches.<sup>82</sup>

The A.T.A.D. Decree did not modify the anti-avoidance rules and anti-abuse regime provided in Article 10-*bis* of Law n. 212 of July 27, 2000, as reviewed by the Legislative Decree n. 128 of August 5, 2015, known as the “Certainty Decree.” It was considered in compliance with the A.T.A.D.

## TAX REGIME FOR HOLDING COMPANIES CLASSIFIED AS S.I.C.A.F.’S

Definitions of undertakings for collective investment (“U.C.I.’s”) and alternative investment fund managers (“A.I.F.M.’s”) are provided by Legislative Decree n. 44/2014 (the “A.I.F.M. Decree”), which implements Directive 2011/61/E.U. (the “A.I.F.M. Directive.”) Some Italian holding companies could be deemed to be S.I.C.A.F.’s that are subject to the tax regime applicable to U.C.I.’s. Such treatment would be an exception to the general rule, that holding companies do not fall within the new definitions of U.C.I. and A.I.F.M.

In particular, both the A.I.F.M. Decree and the A.I.F.M. Directive provide that a holding company is outside the scope of the respective legislation in the following circumstances:

- It is a company that has shareholdings in one or more other companies.
- The commercial purpose of the shareholdings is to carry out a business strategy or strategies through its subsidiaries, associated companies, or participations in order to contribute to their long-term value.
- The company is either (i) operating on its own account and whose shares are admitted to trading on a regulated market in the E.U. or (ii) not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents.<sup>83</sup>

<sup>82</sup> The above-mentioned provisions related to hybrid mismatches have been effective from tax year 2020. The rules addressing reverse hybrid arrangements will enter into force starting from tax year 2022.

<sup>83</sup> See Article 4 of the A.I.F.M. Decree and A.I.F.M. Directive.

Conversely, holding companies other than those described above could fall within the scope of the A.I.F.M. Decree and A.I.F.M. Directive and, in particular, within the definition of a S.I.C.A.F. A S.I.C.A.F. is defined to be (i) a closed-end U.C.I. in the form of a joint stock company having fixed capital, (ii) having a registered office and general management in Italy, and (iii) having as its exclusive purpose the collective investment of assets obtained by the offer of its own shares and other financial instruments of equity held by the same investors. If a holding company is deemed to be a S.I.C.A.F., it is subject to the tax regime applicable to U.C.I.'s, which differs from the tax regime for holding companies described above.

In principle, a U.C.I. is considered liable for tax in Italy as if it were a normal joint stock company, but is exempt from the income tax. As a consequence, the group tax consolidation regime mentioned above is not permitted.

While the S.I.C.A.F. is exempt from income tax, the profits arising from investments carried out by the S.I.C.A.F. are taxed at the level of its investors through the application of a withholding tax. The withholding tax rate will depend on tax residence and subjective status of the investor. The dividend exemption and the participation exemption rules are not applicable to a S.I.C.A.F.

The voluntary transformation of a holding into a S.I.C.A.F. (authorized by the Bank of Italy) leads to immediate taxation of all unrealized gains on its assets because the transformation of a corporation into a “non-commercial” entity is a taxable event in Italy.<sup>84</sup>

## TAX MEASURES TO MITIGATE THE ECONOMIC EFFECTS OF THE COVID-19 PANDEMIC

### Special Emergency Legislation

The Italian Government adopted some tax measures in order to address the economic effects of COVID-19 pandemic:<sup>85</sup>

- Law Decree of March 17, 2020 n. 18. (“*Cura Italia Decree*”), converted into Law of April 24, 2020 n. 27 (subsequently modified, *inter alia*, by Article 1(70) of Law December 30, 2021 n. 234), enacted measures to support taxpayers and to mitigate the economic effects of the COVID-19 pandemic. These measures include deferral for several tax payments and obligations, the introduction of several tax incentives, and the suspension of tax litigation activities.
- Law Decree of April 8, 2020 n. 23 (“*Liquidità Decree*”), converted into Law of June 5, 2020 n. 40, enacted additional measures to support business liquidity. It further deferred deadlines for several tax payments and introduced other tax incentives.

<sup>84</sup> Such position was confirmed by the Italian tax authorities in the recent Answer Ruling n. 370 of May 24, 2021.

<sup>85</sup> The Italian Special Emergency Legislation was adopted in compliance with the European Commission Communication of March 19, 2020 C(2020)1863 final, containing the “Temporary framework for State aid in support of the economy in the current COVID-19 emergency” (hereinafter “Temporary Framework”), as last amended by the Communication of November 18, 2021 C(2021) 8442.



- Law Decree of May 19, 2020, n. 34 (*“Rilancio Decree”*), converted into Law of July 17, 2020, n. 70, provided additional measures to relaunch the economy and mitigate the effects of the COVID-19 emergency.
- Law Decree of August 14, 2020, n. 104 (*“Agosto Decree”*), converted into Law of October 13, 2020, n. 126, introduced further support measures and extraordinary rules within the framework of the COVID-19 emergency.
- Law Decree of October 28, 2020, n. 137 (*“Ristori Decree”*), Law Decree of November 9, 2020, n. 149. (*“Ristori-bis Decree”*), Law Decree of November 23, 2020 n. 154 (*“Ristori-ter Decree”*), Law Decree of November 30, 2020, n. 157 (*“Ristori-quarter Decree”*) – all converted into Law. They provided additional measures in order to support workers and businesses, such as non-refundable grants and suspension of tax payments.
- Law Decree of March 22, 2021, n. 41 (*“Sostegni Decree”*),<sup>86</sup> converted into Law of May 22, 2021 n. 69, Law Decree of May 25, 2021, n. 73 (*“Sostegni-bis Decree”*), converted into Law of July 23, 2021 n. 106, and Law Decree n. 4 of January 27, 2022, converted into Law n. 25 of March 28, 2022 (*“Sostegni-ter Decree”*) provided additional measures within the COVID-19 framework, such as the strengthening of the A.C.E. deduction described above.

Many of the tax incentives provided by the aforementioned Law Decrees are not applicable to holding companies. Consequently, holding companies are not entitled to (i) the tax credit provided for equity contributions<sup>87</sup> and (ii) the elimination of the I.R.A.P. balance payment for 2019 and first advance payment for 2020.<sup>88</sup>

Moreover, since the state of emergency related to the COVID-19 pandemic ended on March 31, 2022, most of the above-mentioned tax measures have been eliminated. The following tax provisions are applicable with reference to years 2021 and 2022.

## **Principal Tax Provisions**

### **Tax Credit on D.T.A.**

Subject to certain conditions, qualifying companies may convert deferred tax assets related to tax losses and unused A.C.E. deductions that are being carried forward into tax credits equal to 20% of the nominal value of the transferred receivables. See Article 55 of the *Cura Italia Decree*. This option was extended by Article 1(70) of Law December 30, 2021 n. 234 until June 30, 2022.

<sup>86</sup> Article 1(13-17) of *Sostegni Decree* introduced an “umbrella scheme” with the aim of granting new State aid under sections 3.1 and 3.12 of the Temporary Framework. Specific reporting obligations were provided by the Decree of the Minister of Economy and Finance of December 11, 2021 and the Provision issued by the Director of the Italian Revenue Agency on April 27, 2022.

<sup>87</sup> Pursuant to Article 26 of the *Rilancio Decree*, subject to certain conditions and caps, taxpayers may benefit from a tax credit related to capital increase (in the form of cash capital contribution), provided that such contributions are fully paid before December 31, 2020.

<sup>88</sup> See Article 24 of the *Rilancio Decree*, as amended by Article 1 of *Sostegni Decree*.

**“A tax credit is granted equal to 30% of the costs borne in June, July and August 2021 for adapting and sanitizing the workplace and implementing COVID-19 safety measures is granted for qualifying taxpayers.”**

### **Tax Credit for Tenants of Business Property**

A tax credit is granted, under certain conditions, equal to 60% of the rent paid for qualifying commercial properties in the period between January 2021 and May 2021, provided the business enterprise continues carrying out business activity during this period.<sup>89</sup> See Article 4 of Law Decree “*Sostegni-Bis Decree*.”<sup>90</sup> Article 5 of *Sostegni-ter Decree* extended the tax credit benefit to rent paid in the period between January 2022 and March 2022 by companies engaged in touristic activity.

### **Industry 4.0 Tax Credit**

The deadline for the delivery of the tangible assets qualifying for the tax credit provided by Article 1(1051-1063) of Law December 30, 2020 n. 178, according to the higher rate provided for 2021,<sup>91</sup> has been extended from June 30, 2022 to December 31, 2022. See Article 3-*quater* of the Law Decree n. 228 of December 30, 2021, converted into Law n. 15 of February 25, 2022.<sup>92</sup>

### **Tax Credit for Safety Measures and Sanitizing Expenses**

A tax credit is granted equal to 30% of the costs borne in June, July and August 2021 for adapting and sanitizing the workplace and implementing COVID-19 safety measures is granted for qualifying taxpayers. The credit is capped at €60,000. See Article 32 of the *Sostegni-bis Decree*.<sup>93</sup>

### **Tax Credit for Investments in Advertising**

A tax credit for advertising investments is increased from 30% to 50% for fiscal year 2020. See Article 186 of the *Rilancio Decree*.<sup>94</sup> Article 1(608) of Law n. 178 of December 30, 2020, extended the tax credit for the advertising investments that occurred in 2021 and 2022.<sup>95</sup>

### **Other Tax Measures**

#### **State Aid**

Enterprises that benefitted from unlawful State Aid may benefit from State Aid adopted in connection with the COVID-19 pandemic under E.U. Commission Communication of March 19, 2020. It does not matter that the unlawful State Aid has not been fully repaid by the enterprise. See Article 53 of the *Rilancio Decree*.

<sup>89</sup> The tax credit is reduced to 30% in the case of complex services contracts or lease of going concern that includes at least one real estate asset.

<sup>90</sup> Article 4 of *Sostegni-bis Decree* extended the tax credit for tenants of business property introduced (for 2020) by the Article 28 of *Rilancio Decree*.

<sup>91</sup> For 2021, the tax credit is equal to 50% of the qualified asset (up to €2.5 million), whilst the rate for 2022 is equal to 40% (up to €2.5 million).

<sup>92</sup> The Industry 4.0 Tax Credit regime was extended (with certain modifications) until 2025 by Article 1 (44) of Law n. 234 December 30, 2021.

<sup>93</sup> A similar tax credit was provided for 2020 by Articles 120 and 125 of the *Rilancio Decree*.

<sup>94</sup> This tax credit, previously equal to 30%, was introduced by Article 98 of the *Cura Italia Decree*.

<sup>95</sup> See Article 67 of *Sostegni-bis Decree* which extended the tax credit to advertising investments made through radio and television.

### Repeal of the V.A.T. and Excise Duties Safeguard Clauses

The safeguard clauses arranging for the increase of the V.A.T. rate and the rate of excise duties on fuels in case of a failure to balance the national budget are repealed. See Article 123 of the *Rilancio Decree*.

### Deferral of the Plastics Tax and the Sugar Tax

The initial application of the plastics tax and the sugar tax is postponed to January 1, 2023. See the Article 1 (12) Law n. 234 of December 30, 2021. It was previously scheduled for January 1, 2022.

### Public Administration Tax Refunds and Payments

For year 2020, and until April 30, 2021, the Italian tax authorities will grant tax refunds without first offsetting any enforceable tax claims against the taxpayer. See Article 145 of the *Rilancio Decree*, as amended by *Sostegni Decree*.

### Increase of the Cap to Offset Tax Credits

For year 2021, the cap to offset social security contributions and tax credits against tax liabilities has been increased from €700,000 to €2,000,000. See Article 22 of *Sostegni-bis Decree*.<sup>96</sup> The cap of €2,000,000 was confirmed for year 2022 onwards by Article 1 (72) Law n. 234 of December 30, 2021.

## **TAX MEASURES TO MITIGATE THE ECONOMIC EFFECTS OF THE INCREASE IN THE COST OF ENERGY**

For 2022, the Italian government approved some tax measures to mitigate the cost of electricity and natural gas as well as the development of renewable sources. See in this respect the *Sostegni-ter Decree*, the Law Decree n. 17 of March 1, 2022 converted into Law 27 April 2022, n. 34 (“Energy Decree”) and the Law Decree n. 21 of March 21, 2022 (“Ukraine Decree”).

The main tax provisions relate to the introduction of new tax credits for companies with medium/high energy consumption. Companies with electricity meter readings over 16.5 kW are eligible for a credit equal to 12% of the expenditure incurred for the purchase of the energy component actually used in the second quarter of 2022. The credit is allowed if the price of the energy costs, calculated on the basis of the average as compared to the first quarter of 2022, exceeds 30% of the corresponding average price for the same quarter of 2019.

Subject to certain conditions, a higher tax credit (respectively, equal to 20% to 25% of the energy cost) is provided for companies with high electricity or natural gas consumption.

<sup>96</sup>

For 2020, the cap was increased up to €1,000,000 by Article 147 of the *Rilancio Decree*.



# GERMANY

## Author

Dr. Wolf-Georg von  
Rechenberg  
BRL Böge Rohde  
Lübbehüsen  
Berlin

## INTRODUCTION

In the past few years, several steps have been taken to make Germany a more attractive jurisdiction for holding companies, especially within the E.U. At the same time, efforts have been made to prevent multinational businesses from using international financing structures which treat interest paid to shareholders as business expenses in Germany while leaving the profits of business operations taxable in tax havens. Germany has implemented all measures recommended under the E.U. Anti-Tax Avoidance Directive (the “A.T.A.D.”) and the recommendations of the O.E.C.D. regarding B.E.P.S. In some respects, Germany has introduced even stricter rules.

In determining Germany’s advantages as an investment location, judgment should not rest solely on the tax rate: whereas the base corporate tax rate of 15% seems to be very attractive, the effective tax rate can range to about 30% due to the added trade tax burden. Nevertheless, preferred tax treatment for dividends received from other companies and capital gains from the sale of participations in addition to an exemption from dividend withholding tax for dividends paid to companies resident in E.U. Member States has ultimately created a competitive tax environment for investments in Germany. This is particularly interesting given that the German economy has not suffered from the worldwide financial crisis to the same extent as other European economies, making Germany an attractive location for holding companies and active investments. In addition, Germany has one of the largest tax treaty networks, with only a few countries, such as Brazil and Saudi Arabia, being excluded.

As of June 2022, the economy of Germany has suffered severely from the COVID-19 crisis, but the government took early action in the form of several big support packages for the economy, in general, and for certain companies relevant to the whole economy, like Lufthansa, TUI, and others. The support packages included several tax measures to help the economy to cope with the pandemic.

## 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.<sup>1</sup> On top of the corporate tax, trade tax must be paid by most companies. Trade tax is a municipal tax and the rate is determined by each municipality, which leads to an effective trade tax rate between 7% and 17%, with the average being 14%. Therefore, the effective tax burden for a corporate entity is about 30%. It

<sup>1</sup> The solidarity surcharge has been abolished for most individual taxpayers as of January 2021, but not for corporate entities.

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 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 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.<sup>2</sup> The participation exemption in partnership structures also applies for trade tax purposes.

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<sup>2</sup> *Körperschaftsteuergesetz* ("KStG," or the German Corporation Tax Act), §8b, ¶6.

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.<sup>3</sup>
- The exemption does not apply to shares held as current assets by a company engaged in financial business (“*Finanzunternehmen*”) that is more than 50% directly or indirectly owned by a financial institution.
- A general exception from the 95% participation exemption exists for banks and financial institutions, and also for life and health insurance companies.

Reductions in profits arising from corporate stock holdings (in particular, extraordinary write-downs) are disregarded in determining taxable income. This exception also applies to shareholder debt in the following circumstances:

- Reductions in profits in connection with a loan (e.g., write-downs to going-concern value, forgiveness of the unrecoverable portion of a debt claim)
- Reductions in profits in connection with securities and guarantees given for a loan
- Reductions in profits resulting from legal acts that are the economic equivalent of a loan

This provision applies to loans made or security posted by (i) substantial shareholders (those holding more than 25% of the share capital either directly or indirectly), (ii) persons related to substantial shareholders, and (iii) third parties with a right of recourse against substantial shareholders and their related persons. The statute continues to apply even when the shareholder is no longer a substantial shareholder at the time of the reduction in profits.

The denial of a deduction does not apply where it is shown that an unrelated third party would have made the loan under the same circumstances or would not have required its repayment (arm’s length exception). Only security given by the company in question (the debtor) is taken into account for purposes of the arm’s length exception.

### **Dividend Exemption**

The dividend exemption applies to dividends received from domestic and foreign participations.<sup>4</sup> For corporate tax purposes, there is no holding period. However, the dividend exemption applies only if the corporation receiving the dividend holds, at a minimum, a participation of 10%.<sup>5</sup> Below that threshold, the entire dividend payment is subject to tax at a normal rate of about 30%, including trade tax.

The dividend exemption also applies for trade tax purposes, if a participation of at least 15% has been held at the beginning of the tax year. In the case of foreign

<sup>3</sup> *Id.*, §8b, ¶2, sent. 4.

<sup>4</sup> *Id.*, §8b, ¶1.

<sup>5</sup> *Id.*, §8b, ¶4.

*“Only security given by the company in question (the debtor) is taken into account for purposes of the arm’s length exception.”*

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 **General Participation and Dividend Exemption**.

If the entity receiving the dividend has a participation of less than 10% in the paying entity, the dividends received do not qualify for the exemption and are not deemed to be 5% nondeductible.

### **Financing Expenses**

Despite the capital gains and dividend exemption, financing costs related to the acquisition of shares are, in principle, fully deductible for corporate tax purposes, within the limitations of the earning stripping rules discussed at **Earnings Stripping Rules**, below. This is an exception to the general rule of German tax law which provides that business expenses incurred in relation to tax-exempt income, such as dividends or capital gains, are not tax deductible.<sup>6</sup>

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
- 50% of rental and leasing payment for immovable fixed assets
- 25% of payments to obtain license rights for a limited time period, except for licenses that merely confer entitlement to license to third parties the rights derived thereunder

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<sup>6</sup> *Einkommensteuergesetz* ("EStG," or the German Income Tax Act), §3c, ¶1.

The additional deductions that may be claimed 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.<sup>7</sup>

## EARNINGS STRIPPING RULES

### General Concept

Several years ago, earnings stripping rules were introduced into the German income tax law, replacing the former thin capitalization rules.<sup>8</sup> 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. (generally referred to as the “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. It simply may be claimed as a deduction to the extent the net interest expense in the subsequent year is less than the 30% of E.B.I.T.D.A. for that year. In a similar way, any tax E.B.I.T.D.A. amount that is not consumed by interest expense for the purpose of the earnings stripping rules in a particular year may also be carried forward (known as “E.B.I.T.D.A. carryforward”) to increase the ceiling in the carryforward year.

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<sup>7</sup> The active business requirement is not applicable to companies resident in an E.U. Member State.

<sup>8</sup> EStG, §4h; KStG, §8a.

## **Exemptions**

A *de minimis* rule applies to the earnings stripping limitations on the deductibility of net interest expense. The earnings stripping rules apply only when interest expense exceeds positive interest income by at least €3 million (the “tax threshold”). Thus, small- and medium-sized business enterprises are generally exempt from the scope of the earnings stripping rules, provided the tax threshold for a year is not reached or exceeded.

The earnings stripping rules also do not apply to businesses that are not 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 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 has an equity ratio – viz., the percentage of balance sheet assets funded by equity – that is equal to or greater than the equity ratio of the controlled group, the earnings stripping rules do not apply. There is a 2% safety cushion for the equity ratio of the business in question. Consequently, the escape clause may be met when the equity ratio of the entity is 48% and the equity ratio of the controlled group is 50%. As indicated above, the calculation of the equity percentage of the business must be based on the values of the assets and liabilities as reflected in the consolidated financial statements.

The exemption for non-controlled corporations and the escape clause apply only if the corporation establishes that remuneration on shareholder debt accounts does not exceed 10% of the net interest expense of the relevant entity.<sup>9</sup> Shareholder debt is defined as debt that is granted by a substantial shareholder,<sup>10</sup> by an affiliated person, or by a third-party having recourse against a substantial shareholder or affiliated person. Debt financing between companies of the same consolidated group is not adversely affected by these rules.

## **RESTRICTING TAX DEDUCTIONS ON LICENSE PAYMENTS**

There is a limit on the amount of a deduction that may be claimed for license payments.<sup>11</sup>

The section restricts the deduction of royalties and similar payments made to related parties if, in the other country, the payments are (i) subject to a preferential

<sup>9</sup> KStG, §8a, ¶2.

<sup>10</sup> Shareholder of more than 25%.

<sup>11</sup> EStG, §4j.



tax regime, such as an I.P. Box regime, and the rules in the other country are not compliant with the O.E.C.D. nexus approach presented in the B.E.P.S. Report on Action Item 5 and (ii) subject to an effective tax rate of less than 25%. A safe harbor exists for royalty payments to a company that carries on substantial research and development activities.

The percentage of the payment that will be nondeductible is calculated by making reference to the percentage shortfall between the effective rate and 25%. Stated mathematically, the formula is  $(25\% - \text{effective tax rate}) \div 25\%$ . For 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%.

This also captures indirect license payments and will apply irrespective of any tax treaties (*i.e.*, treaty override).

## LOSS CARRYFORWARD

As a general rule, losses incurred in one fiscal year may be carried forward to following fiscal years. The deduction of losses incurred in previous years is limited by the minimum taxation rules.<sup>12</sup> According to these rules, up to €1 million in losses may be deducted in full in any single subsequent year. As a measure of the COVID-19 package, the amount has been extended to €5 million for the years 2020 and 2021. From the year 2022, the old rules are applicable again. In addition, 60% of the amount exceeding €1 million (€5 million for 2020 and 2021) can be used. This means that if a company has losses carried in the amount of €2 million, it may use only €1.6 million even if it has a higher profit in this year (“minimum taxation rule”). The nondeductible amount (40% in excess of €1 million) will again be carried forward.

The remaining losses are carried forward and can be used in future years within the limits described above of the minimum taxation rule.

A loss carryover may be reduced or eliminated if a change in ownership exists in the company incurring the loss. The rules in Germany's KStG address the following situations:

- Losses are cancelled in full if more than 50% of the shares of a corporation are transferred within a period of five years. This rule has been questioned in court with regard to its possible violation of constitutional law. The lower Tax Court of Hamburg has submitted a case to the Constitutional Court and is awaiting a final decision.<sup>13</sup> No decision has been published yet.
- In the past, losses were cancelled in proportion to the percentage of shares transferred if more than 25% but less than 50% of the shares in a corporation were transferred within a period of five years. As a consequence of another decision of the Constitutional Court, this rule was abolished.<sup>14</sup>

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<sup>12</sup> *Id.*, §10b.

<sup>13</sup> FG Hamburg, Beschluss v. 11.4.2018, 2 V 20/18, EFG 2018 S. 1128; FG Hamburg Beschluss v. 29.08.2017, 2 K 245/17, DStR 2017, 2377.

<sup>14</sup> Beschluss v. 29.3.2017, 2 BvL 6/11, BGBl I 2017 S. 1289.



A special rule was incorporated into §8c KStG in order to facilitate the preservation of losses during the takeover of a crisis-stricken company. An attempt by the European Commission (“the Commission”) to classify this as unlawful State Aid was rejected by the European Court of Justice (“E.C.J.”).<sup>15</sup> Therefore, §8d KStG, which relaxes the rules regarding cancellation of losses carried forward for share transfers within groups of companies or if the company’s business continues without major changes following the transfer, is applicable for share transfers of 50% or more.

Existing losses can be preserved following a share transfer aimed at avoiding a company’s bankruptcy if the essential operating structures of the business remain, which requires that one of the following prerequisites is met:<sup>16</sup>

- There is a works council agreement on the restructuring scheme that includes provisions for the preservation of a certain number of jobs.
- In the five years following the share transfer, the company pays at least 400% of the wages it has paid in the five years preceding the transfer.
- The company’s equity is raised by at least 25% of the company’s assets.

A company’s losses may also be preserved following a change in ownership where the losses cannot be used otherwise.<sup>17</sup> In cases where a new shareholder or a change in shareholders is necessary for the company receive proper financing to avoid bankruptcy, the loss carryforward may be preserved if the company maintains the same business activities as prior to transfer. Business activities encompass the company’s services or products, its customers and suppliers, the markets it serves, and the qualification of its employees. Further restrictions may also apply. The losses can be carried forward until they are fully used so long as no adverse event occurs, such as the closing of the business or the implementation of new business activities.

## REAL ESTATE TRANSFER TAX ON SHARE TRANSFER TRANSACTIONS

Under current law, transfers of more than 95% of the shares of a corporation that owns real estate in Germany can trigger the imposition of real estate transfer tax. The tax may be levied if the company or its subsidiaries own real estate. Moreover, the trigger looks at the aggregate of all transfers within a 10-year window. The tax rate varies between 5% and 6.5% depending on the Federal state in which the real estate is located. The tax base is not calculated based on market value or book value, but through a special assessment procedure. A specific anti-avoidance rule exists.

It was expected that these rules would be tightened in 2019. Among other things, the trigger would be lowered from 95% to 90% change in owners and the window would be expanded from 10 years to 15 years. However, the revisions remain in draft form as of June 30, 2021.

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<sup>15</sup> EuGH, Urteil v. 28.6.2018, C-203/16 P, C-208/16 P, C-219/16 P, C-209/16 P.

<sup>16</sup> KStG, §8c.

<sup>17</sup> *Id.*, §8d.



## C.F.C. TAXATION

German tax law provides specific regulations for a shareholder of a controlled foreign corporation (“C.F.C.”) to curtail the perceived abuse of shifting income into low-tax jurisdictions.<sup>18</sup> Based on A.T.A.D. 2 and the Respective Transfer Act,<sup>19</sup> several adjustments have been implemented to comply with the directives. They are applicable for fiscal years beginning on or after January 1, 2022. The C.F.C. rules apply if all of the following conditions are met:

- More than 50% of the share capital or voting rights in the foreign intermedia company are held by a taxpayer who is subject to unlimited tax liability in Germany.
- The foreign corporation generates passive income.
- The foreign corporation is subject to low taxation (*i.e.*, its effective tax burden as determined according to German tax principles is below 25%).

Passive income is defined as income that is not explicitly classified as active under the C.F.C. regulations. Classified active income includes income from manufacturing, trading, the provision of services, and some forms of licensing and renting, with the exception of certain structures designed to reallocate taxable income from Germany to a tax haven. Dividends, constructive dividends, and, in principle, capital gains are active income, as well. The classification of capital gains as active income depends on the activity of the target company sold by the C.F.C.

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 above-mentioned conditions are fulfilled, passive income as determined under German tax legislation is apportioned to all German-resident individual and corporate shareholders. The apportioned income is treated as a profit distribution received in the year following the year in which it is realized by the C.F.C. The German shareholder does not benefit from applicable treaty provisions, and the general dividend exemption does not apply.<sup>20</sup> The income is now subject to the income of the shareholder for trade tax purposes.

Losses of the C.F.C. are not deductible by the German shareholder, but they may only be carried backward against profits of the C.F.C. to offset C.F.C. dividend income of the shareholder.

*“Special rules apply for companies generating investment type income.”*

<sup>18</sup> *Außensteuergesetz* (“AStG,” or the German Law on Taxation in Foreign Relations), §7.

<sup>19</sup> Directive EU 2027/952 of 29.05.2017 and ATAD-Transfer Act (ATAD-UmsG) of 25.06.2021 = BGBl. 2021 I, 2035).

<sup>20</sup> Foreign Relations Taxation Act, §10, ¶2, sent. 3 (“F.R.T.A.”).

An exemption from the C.F.C. rules applies for a C.F.C. that maintains its registered office or place of management in a member country of the E.U. or E.E.A., provided the company carries on genuine economic activities in that country.<sup>21</sup> Genuine economic activities require a full-fledged business with an appropriate office, employees, and technical equipment. Generally, “genuine economic activities” are determined by the criteria stated by the E.C.J. in the *Cadbury Schweppes* decision. Only such income that is attributable to the genuine economic activity and that is derived by that particular activity is exempt from the C.F.C. rules, and only for amounts that do not exceed arm’s length consideration.

Overall, the new rules are more detailed and require meticulous preparation, and in many cases, active reporting to the tax administration.

Within the package of new rules, the conditions for the German exit tax system have also been substantially changed.

## DIVIDEND WITHHOLDING TAX; TREATY NETWORK; ANTI-ABUSE PROVISIONS

### Withholding Tax

A nonresident’s dividend income is subject to withholding tax collected at the source. The statutory rate of German withholding tax is 25% (plus the solidarity surcharge of 5.5%). Foreign corporations may claim a refund of two-fifths of the withholding tax (the effective withholding tax rate is 15% plus the solidarity surcharge). In many cases, lower rates will be levied under a double tax treaty. No dividend withholding tax will be levied on dividends paid to a parent company resident in the E.U., if the parent has been holding a participation of at least 10% in the subsidiary for the last 12 months.<sup>22</sup>

### Treaty Network

Germany has an extensive income tax treaty network with almost 100 income tax treaties in force and effect as of May 2019.

Albania	France	Lithuania	South Africa
Algeria	Georgia	Luxembourg	South Korea
Argentina	Ghana	Macedonia	Spain
Armenia	Greece	Malaysia	Sri Lanka
Australia	Hungary	Malta	Sweden
Austria	Iceland	Mauritius	Switzerland
Azerbaijan	India	Mexico	Syria
Bangladesh	Indonesia	Moldova	Taiwan
Belarus	Iran	Mongolia	Tajikistan
Belgium	Ireland	Montenegro	Thailand
Bolivia	Israel	Morocco	Trinidad & Tobago
Bosnia & Herzegovina	Italy	Namibia	Tunisia

<sup>21</sup> *Id.*, §8, ¶2.

<sup>22</sup> EStG, §43b, ¶2.

Bulgaria	Ivory Coast	Netherlands	Turkey
Canada	Jamaica	New Zealand	Turkmenistan
China	Japan	Norway	Ukraine
Costa Rica	Jersey	Pakistan	U.A.E.
Croatia	Kazakhstan	Poland	U.K.
Cyprus	Kenya	Portugal	U.S.A.
Czech Republic	Kosovo	Romania	Uruguay
Denmark	Kuwait	Russia	Uzbekistan
Ecuador	Kyrgyzstan	Serbia	Venezuela
Egypt	Latvia	Singapore	Vietnam
Estonia	Liberia	Slovakia	Zambia
Finland	Liechtenstein	Slovenia	Zimbabwe

Germany has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Germany has nominated the treaties with France, Greece, Italy, Japan, Croatia, Luxembourg, Malta, Austria, Romania, Slovakia, Spain, the Czech Republic, Turkey, and Hungary for modification under the MLI, which came into force in April 2021.

### **Anti-Abuse Provisions**

Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies.<sup>23</sup> 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.

For shareholdings of less than 10%, withholding tax is applicable for both resident and nonresident shareholders. A different holding percentage may be applicable under the various treaties that are in effect.

Legislation was enacted in 2021, addressing the following anti-abuse provisions for transactions involving companies based in a noncooperative jurisdiction:

- The disallowance of deduction for operating expenses and income-related expenses ultimately paid to a noncooperative jurisdiction
- Stricter taxation in cases of intermediate companies

<sup>23</sup> *Id.*, §50d, ¶3.



- Tougher withholding tax measures in the case of profit distributions to a shareholder in a noncooperative jurisdiction
- Full taxation if shares of a subsidiary in a noncooperative jurisdiction is disposed of by a German resident

## 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.

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 constructive dividend even if the transaction is carried out at arm's length.

The arm's length principle is also applicable for any transaction with a permanent establishment.

### **Transfer of Functions**

Provisions on the transfer of functions are included in the transfer pricing legislation. A function is transferred if it is relocated abroad with the associated opportunities and risks, including the assets and other benefits, also transferred or otherwise provided.

In principle, a payment in consideration of the transfer shall be calculated for the transfer as a whole. The calculation of this payment is to be based on the impact of the function shifted on the profits of the transferring and receiving companies. The administration has issued an extensive legal decree ("*Funktionsverlagerungsverordnung*") and administrative guidelines with practical examples.

### **Documentation Requirements**

Germany has introduced extensive rules regarding transfer pricing documentation and penalties. According to the rules, a German taxpayer must document the type of cross-border business transaction carried out with a related party or a permanent establishment abroad and the reasons for setting the transfer price. For

extraordinary business transactions, documentation must be prepared on a contemporary basis. On the other hand, for ordinary business transactions, documentation must be presented within 60 days (for extraordinary transactions, within 30 days) of a request during a tax audit. The Federal Ministry of Finance has issued a Federal ordinance on transfer pricing documentation obligations, which has been supported by a decree from the tax authorities.

If a taxpayer fails to comply with the documentation requirements, there is a rebuttable presumption that the income of the German taxpayer is understated. The tax authorities are granted broad discretion to estimate the income of the taxpayer from the transaction. In addition, penalties may be due. The penalties range from 5% to 10% of the additional estimated income, with a minimum penalty of €5,000. If documentation is not presented on a timely basis, penalties of €100 may be imposed for each day of the delay up to €1 million.

*“If a taxpayer fails to comply with the documentation requirements, there is a rebuttable presumption that the income of the German taxpayer is understated.”*

## GERMAN INVESTMENT LAW TAXATION

Until relatively recently, investment funds have been exempt from taxation and only individual investors were subject to tax, even if gains were not distributed. This favorable treatment of investment funds has changed:

- Gains will be taxed at the level of the fund, not at the level of the investors.
- All funds are taxed according to the same scheme: on the basis of an annual lump sum.
- At the fund level, investment funds are partially subject to corporate tax on their domestic dividends, domestic rents, and profits from the sale of domestic real estate. The tax rate is 15% in each case, with an additional solidarity surcharge applicable to items other than domestic dividends.
- At the investor level, all distributions and profits from the sale of shares are in principle taxable. The aim is to tax national and foreign public investment funds equally.
- In order to avoid double taxation, certain distributions will be partially exempt from tax.

The Federal Ministry of Finance has issued several letters on the application of these rules.

## MEASURES ON THE COVID-19 CRISIS

Through mid-2021, the German legislature launched a series of tax-related measures as part of various aid packages in connection with the COVID-19 crisis. Most of these measures have been extended to date.

Most of these measures are explained in a Q&A catalogue published by the Federal Ministry of Finance, which is updated on an ongoing basis.

As of June 30, 2022, the principal tax measures are described below.



### **Adjustment of Tax Prepayments**

Taxpayers who claim that their business activities are affected by the pandemic can apply for an adjustment of the tax prepayments on an application form that is also available electronically.

### **Deferral of Assessed Taxes**

Taxpayers affected by the COVID-19 pandemic can apply for deferral of taxes that have already been assessed, stating the background. As a rule, no deferral interest is to be set. The deferrals should initially be granted for three months, with the possibility of an extension until December 31, 2022 subject to requirements that are not too strict.

### **Submission of Tax Returns**

The deadline for submitting tax returns has been extended beyond the previously applicable deadlines.

### **Loss Carryback**

For the years 2020 and 2021, the tax loss carryback will be extended to €5 million and €10 million (in the case of joint assessment), and a mechanism will be introduced to make the loss carryback for 2020 directly effective as early as the 2019 tax return. This rule has expired.

### **Taxation of Employees**

For employees, various benefits are provided in connection with the work in the home office. A tax-free COVID-19 bonus may be paid to employees.

### **Annual Accounts**

No administrative fine should be imposed by the competent authority on companies which fail to prepare their annual financial statements on time and cannot publish them within the statutory time limits, provided the relevant measure is taken by July 1, 2022.

### **V.A.T.**

In addition to the already mentioned reduction of the V.A.T. from 19% to 16% and from 7% to 5% for the period from July 1, 2020, to December 31, 2020, there are further measures in connection with the V.A.T. and practical means of its collection.

### **Cross-Border Commuters**

For cross-border commuters who as a result of the COVID-19-related restrictions on their activities are unable to carry out their activities across the border as usual, and who therefore have to fear negative tax consequences because the conditions for cross-border commuting are no longer met, arrangements have been made with some states by means of consultation agreements on the Double Taxation Agreements which take into account the special situation. This applies, for example, to the Netherlands, Luxembourg, and Austria. Similar considerations exist for France and Switzerland.

## **Permanent Establishments**

Insofar as, due to the COVID-19 pandemic, the conditions for the establishment and maintenance of business premises, in particular for construction and assembly work, cannot be complied with, the German tax authorities are of the opinion that COVID-19-related interruptions should not be included.

In principle, the provisions of the double taxation agreements should continue to apply as far as the question of the domicile of companies with regard to the seat of the management is concerned. However, the periods during which employees or managers are not mobile due to the COVID-19 pandemic should not result in any change in the question of permanent establishments and their establishment or relocation. In this respect, the German tax authorities are likely to follow the O.E.C.D.'s thinking on this issue.

## **Reporting Requirements for Cross-Border Tax Arrangements**

The D.A.C. 6 directive has been transposed into the German General Tax Code into §138a to 138k AO. Accordingly, this reporting obligation came into force on July 1, 2020.

## **Transparency Register**

Although it is not based on tax law but on money-laundering law,<sup>24</sup> the introduction of the German Transparency Register is also important to mention. From the year 2022, with different starting dates for different types of entities, all legal entities active in Germany have to file with this new register. The filing includes basic information about the type of entity, its entry in public registers, its share capital, and its place of business. The most important requirement is that the entity must report the entire chain of shareholders up to the ultimate beneficial shareholder. This also requires entities to provide information on indirect shareholdings or trust agreements. The failure to accurately report this information will be penalized. Although the register is not public, the tax authorities as well as other persons with legitimate interest will have access.

## **Further Measures**

In addition, further measures are planned, such as an extension of tax incentives for research expenditure, the extension of reinvestment periods, and an increase in degressive depreciation to up to 25%, but no more than two and a half times linear depreciation.

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<sup>24</sup>

Money Laundering Act 23.06.2017, amended 23.06.2022. Federal Gazette I, p. 754.

# CYPRUS

## Author

Nairy Der Arakelian-Merheje  
Der Arakelian-Merheje LLC  
Nicosia

## 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 the following:

- Its strategic geographic location
- A favorable tax package with one of the lowest corporate tax rates in Europe
- A well-developed double tax treaty network
- A legal system and legislation based on English law
- The existence of an efficient, high-level professional services sector

The Constitution of Cyprus and international treaties ratified by Cyprus safeguard the basic rights of legal entities and individuals.

The main tax provisions relating to Cypriot holding companies have recently been revised to adhere to E.U. directives based on the O.E.C.D.'s recommendations for combatting base erosion and profit shifting ("B.E.P.S. Project"). Tax structures are now carefully scrutinized with regard to the commercial reasoning behind various arrangements.

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**

### **Corporations**

The concept of residency status for corporations was adopted in 2003, and tax liability in Cyprus is dependent upon the status of a company as a resident. This is determined by examining the exercise of management and control in Cyprus.

Although "management and control" is not defined in Cypriot tax legislation, it is generally accepted to be in line with international tax principles, 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. Of extreme importance, directors must have suitable qualifications to carry out responsibilities.
- A physical administrative office is maintained in Cyprus, from which actual management and control of the business is exercised.
- Hard copies of commercial documentation (e.g., agreements and invoices) are stored in the company's office facilities in Cyprus.
- Accounting records of the company are prepared and kept in Cyprus.
- Bank accounts of the company are operated from Cyprus, even if the accounts are maintained with banks established outside Cyprus.

#### *New Additional Corporate Tax Residency Test*

In December 2021, an amendment to the Income Tax Law was published in the Cyprus Government Gazette (the "law amendment") in which an additional corporate tax residency test was introduced based on incorporation. This additional test aims to capture companies incorporated or registered in Cyprus that are not tax resident in any other jurisdiction.

In accordance with the law amendment, the definition of resident in the Republic is expanded so that a company established or registered under any applicable law in the Republic is considered to be a resident of Cyprus even if its management and control are exercised from outside Cyprus, unless the company is tax resident in any other jurisdiction.

This means that companies incorporated or registered in Cyprus with management and control exercised outside of Cyprus will now be considered as Cyprus tax residents taxed in Cyprus on their worldwide income if they are not tax resident in any other jurisdiction.

The law amendment will enter into force on December 31, 2022.

#### *Individuals and Executives of Corporations*

An individual is considered to be resident in Cyprus for income tax purposes if physically present in Cyprus for a period exceeding 183 days in aggregate during a tax year.

An individual who is not physically present in any other state for a period exceeding 183 days in the aggregate during the same tax year and who is not a tax resident of any other state under the laws of that state may also be considered a tax resident of Cyprus for income tax purposes, when the following conditions are met:

- The individual is present in Cyprus for at least 60 days during the tax year.
- The individual pursues any business in Cyprus, works in Cyprus as an employee or independent consultant, or is a director of a company tax resident in Cyprus at any time during the tax year.

- The individual maintains a permanent residence in Cyprus that is either rented or owned.

This broadened definition of individual residence should have the effect of allowing an individual to be treated as a resident of Cyprus for income tax treaty purposes.

### Remuneration Exemptions

A 50% exemption applies to remuneration in excess of €100,000 per annum received in connection with any corporate office or employment held in Cyprus by an individual who is tax resident outside of Cyprus prior to the commencement of employment. This exemption applies for the first ten years of employment. The 50% exemption is not available to an individual whose employment began on or after January 1, 2015, if the individual were a tax resident of Cyprus during (i) three out of the five years preceding the year in which employment commences or (ii) in the year directly preceding the year in which employment commences.

A 20% exemption applies to remuneration received in connection with any corporate office or employment held in Cyprus by an individual who was resident outside of Cyprus prior to the commencement of employment. This exemption applies to employment beginning during or after 2012, for a period of five years beginning on January 1 of the following year. This exemption will apply through 2020 and is not available to individuals who claim the 50% exemption.

### 90-Day Rule

Remuneration for salaried services rendered outside Cyprus for a non-Cypriot tax resident employer or to a foreign permanent establishment of a Cypriot-resident employer for more than 90 days in a tax year is exempt from income tax in Cyprus. Again, this provision should be helpful for individual residents of Cyprus who regularly work for an employer based outside of Cyprus to the extent that an income tax treaty may eliminate tax in the source country.

## **E.U. ANTI-TAX AVOIDANCE DIRECTIVE (“A.T.A.D. 1” AND “A.T.A.D. 2”)**

On June 19, 2020, the Cypriot House of Representatives enacted amendments to the law to implement the first three provisions of the European Union (“E.U.”) Anti-Tax Avoidance Directive 1 (“A.T.A.D. 1”), *i.e.*, the limitation of interest rules, the C.F.C. rules, and the general anti-abuse rules, which came into effect on January 1, 2019. The remaining two provisions, the exit taxation rules and the hybrid mismatch rules, were introduced on July 3, 2020 and came into effect on January 1, 2020, except for the provisions on reverse hybrid mismatches which come into effect on January 1, 2022.

## **EXIT TAXATION RULES**

A company which is tax resident in Cyprus or a non-Cypriot tax resident company which has a permanent establishment (“P.E.”) in Cyprus, will be subject to tax on the excess of the market value of the transferred assets at the time of exit of the assets over the carrying value of the assets for tax purposes, in any of the following cases:

*“This broadened definition of individual residence should have the effect of allowing an individual to be treated as a resident of Cyprus for income tax treaty purposes.”*

- A Cypriot tax resident company transfers asset(s) from its head office in Cyprus to its P.E. in another Member State or in a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.
- A non-Cypriot tax resident company with a P.E. in Cyprus transfers assets from its P.E. in Cyprus to its head office or another P.E. in another Member State or in a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.
- A Cypriot tax resident company transfers its tax residence from Cyprus to another Member State or to a third country, except for those assets which remain effectively connected with a P.E. in Cyprus.
- A non-Cypriot tax resident company with a P.E. in Cyprus transfers the business carried on by its P.E. from Cyprus to another Member State or to a third country in so far as Cyprus no longer has the right to tax the transferred assets due to the transfer.

## HYBRID MISMATCH RULES

Broadly speaking, the purpose of the anti-hybrid mismatch rules of A.T.A.D. 2 is to ensure that deductions or credits are only taken in one jurisdiction and that there are no situations of deductions of a payment in one country without taxation of the corresponding income in the other country concerned. The rules are typically limited to mismatches as a result of hybridity and do not impact the allocation of taxing rights under a tax treaty.

## REVERSE HYBRID MISMATCHES

In relation to the rules regulating reverse hybrid mismatches, which came into effect on January 1, 2022, the amendment applies in situations where one or more associated non-Cypriot tax resident entities holding in aggregate a direct or indirect interest in 50% or more of the voting rights, capital interests, or rights to a share of profit in a hybrid entity that is incorporated or established in Cyprus are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person. The hybrid entity shall be regarded as a Cypriot tax resident and taxed on its income under income tax and special defense contribution, to the extent that that income is not otherwise taxed under the laws of Cyprus or any other jurisdiction.

## CAP ON INTEREST EXPENSE

On April 5, 2019, Cyprus passed legislation implementing the A.T.A.D. in the form of interest limitations to discourage artificial debt arrangements. Deductibility of interest has been limited so as not to exceed 30% of taxable income before taking into account the following items: (i) the excess of interest cost over interest income, (ii) taxes, (iii) depreciation of assets, and (iv) amortization of assets, together referred to as “E.B.I.T.D.A.” The limitation applies to interest expense under intra-group loans as well as third party loans.

There are some exemptions in the following instances:

- As an alternative to the cap based on E.B.I.T.D.A., up to \$3.0 million of interest may be deducted in all circumstances.
- This does not apply to companies that do not form part of a group and without related profit participation of at least 25%.

Companies in certain businesses are exempt from the ceiling on interest expense. Included in the exemption are credit institutions, investment firms, undertakings for collective investments in transferable securities (“U.C.I.T.S.”), insurance business, and pension institutions.

Subject to conditions, a corporate taxpayer may fully deduct excess interest if it can demonstrate that the ratio of its equity over its total assets is equal to or greater than the equivalent ratio of the group.

## CONTROLLED FOREIGN COMPANY (“C.F.C.”) RULES

In broad terms, the C.F.C. rules are intended to deter profit shifting to a low-tax/no-tax country. A C.F.C. is defined as an entity or a permanent establishment (“P.E.”), not taxable in Cyprus, where the following conditions are met:

- The Cypriot tax resident company, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in such entity. The threshold is determined in terms of participation in the share capital, voting rights, or the entitlement to profits.
- The company or P.E. is low-taxed, *i.e.*, the income tax it pays is less than 50% of the Cypriot corporate income tax that it would have paid by applying the provisions of the Cypriot income tax law.

When a company is a C.F.C., its undistributed profits resulting from arrangements that are not genuine are added to the taxable person resident in Cyprus who holds the shares in the C.F.C. when the arrangements have been put in place in order to secure a tax advantage.

There is no allowance or exemption in place that would apply to a C.F.C. whose accounting profits

- do not exceed €750,000 and whose passive income does not exceed €7,000, or
- do not exceed 10% of its operating costs for the tax period.

An arrangement is regarded as non-genuine to the extent that the entity would not own the assets or would not have undertaken the risks which generate all, or part of, its income, if it were not controlled by a company that carries out significant employee functions that are instrumental in generating the controlled company’s income.

Computation of C.F.C. income is in accordance with Cyprus tax laws and in proportion to the taxpayer’s profit share entitlement. Calculations ensure there is no

double taxation. Any foreign tax paid is granted as a tax credit on the basis of the Income Tax Law sections 35 and 36.

## GENERAL ANTI-ABUSE (“G.A.A.R.”) RULE

These rules counteract aggressive tax planning. Cyprus will disregard an arrangement or a series of arrangements where the main purpose or one of its main purposes is to obtain a tax advantage contrary to the object or purpose of the tax laws. Where the tainted purpose exists, the arrangement is deemed not to be genuine. This means that, when taking into account all relevant facts and circumstances, it has not been put in place for valid commercial reasons reflecting economic reality. Where arrangements are ignored, the tax liability is calculated in accordance with the Cypriot income tax law.

## PERMANENT ESTABLISHMENTS

In Cypriot income tax law, the definition of a P.E. 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.

## NOTIONAL INTEREST DEDUCTION (“N.I.D.”) ON EQUITY

### Former Provisions

In the past, interest paid was deducted while calculating the taxable income only when such interest was actually incurred on a loan or other credit facility obtained. The deductibility of the interest expense depended on whether the loan proceeds were used to finance taxable operations of the company or to acquire assets used in the business.

Interest paid in connection with intercompany loans was deductible, provided certain acceptable margins were maintained at the level of the Cypriot-resident company. In practice, the use of back-to-back loans creates beneficial ownership issues under double tax treaties. The issue is a hot button issue in the E.U. as a result of the Danish Cases discussed elsewhere in this compendium.

In the Danish Cases, the European Court of Justice (“E.C.J.”) held that European law contains an inherent concept that a lender receiving interest should not be considered to be the beneficial owner of the interest if an obligation exists to pay the proceeds of the interest to a third party pursuant to a separate borrowing. Consequently, back-to-back loans are being phased out and banks no longer remit funds in the second leg of a back-to-back arrangement except when all parties are related companies.

It should be noted that deductions for interest paid on borrowings to finance the acquisition of investments is allowed only in the case of wholly owned subsidiaries acquired after January 1, 2012.



## **New Provisions**

Cyprus has introduced provisions to allow the N.I.D. in cases where investment is by way of equity instead of interest-bearing loans. Similar provisions have existed for years in other European jurisdictions, such as Belgium and Italy.

The main provisions of the law are as follows:

- A deemed interest deduction will be allowed on “new equity” funds introduced into a Cyprus-resident company in order to carry on the business of the company.
- The deemed interest will be calculated on the basis of a reference interest rate. This rate is equal to the yield on the ten-year government bonds of the country where the new funds are invested, plus 5%.
- If that country has not issued any government bonds during the relevant period, the reference rate is the yield on a ten-year government bond of Cyprus as of December 31 of the year preceding the tax year, plus 5%.
- New equity means any equity funds introduced into the business after January 1, 2015, not including capitalization of reserves resulting from appreciation of movable and immovable property.
- Equity includes both share capital and share premium to the extent that it has actually been paid up. The consideration for the issuance of the shares can be assets other than cash. In that case, the value of the loan cannot exceed the market value of the assets contributed. Other forms of equity contribution are not acceptable.
- The notional interest to be deducted cannot exceed 80% of the taxable income of the company, computed without taking into account the deduction of the notional interest. Consequently, in years with a tax loss, the N.I.D. cannot be claimed.
- The deductibility of the deemed interest are subject to the same rules as actual interest paid. Hence, it is not deductible unless the proceeds relate to assets used in the business of the Cypriot company.
- Claiming the N.I.D. is at the discretion of the taxpayer on a yearly basis.

As the deemed interest is not paid, deducted but not paid N.I.D. should not be covered by provisions in the Multilateral Instrument (“M.L.I.”) and the E.U. Parent-Subsidiary Directive (“P.S.D.”) that deny the participation exemption for dividends that are deductible in the payor’s country of residence.

## **Anti-Avoidance Provisions**

Several anti-avoidance provisions are included in the legislation to protect against abuse of the new benefits, such as “dressing up” old capital into new capital, claiming 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 N.I.D. 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, in a separate transaction, Company B distributes profits to Company A, the dividends received by Company A should be exempt from taxation in the hands of Company A, at least in principle.
- In cases where funds are used on back-to-back loans, beneficial ownership issues for interest received under an income tax treaty are subject to strict scrutiny. As previously mentioned, back-to-back loans were successfully challenged in the E.C.J. in the Danish Cases and are being phased out in Cyprus.

To illustrate, assume Company A, a resident of Country A, borrows funds from Company B, a resident of Country B. Company A lends the same funds to Company C, a resident of Country C. No treaty exists between Country A and Country C. In this case, the tax authorities of Country C may refuse tax treaty benefits when Company C makes payments to Company A because Company A is obligated to pay 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. Of course, if Company A pays dividends to Company B within a relatively short time after receiving interest from Company C, the principle enunciated in the Danish Cases arguably could be applicable.

## **EXPANSION OF THE DEFINITION OF THE REPUBLIC OF CYPRUS**

The law has been amended so that the definition of the term "Republic of Cyprus" now includes, specifically and clearly, the territorial sea, the contiguous zone, the exclusive economic zone, and the continental shelf of Cyprus.

The law has also been amended so that the definition of a permanent establishment now includes all activities for the exploration and exploitation of the seabed in the exclusive economic zone and services related to such exploration or exploitation activities.



Gross income earned from sources within Cyprus (including those mentioned above) by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus that provides services listed above at **Income Tax** would be subject to tax at the rate of 5%.

## TAX LOSSES GROUP RELIEF

Under the current provisions of the law, group loss relief can only be given for losses incurred by 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.

## REORGANIZATION OF COMPANIES AND ANTI-AVOIDANCE PROVISIONS

The E.U. directive on mergers, acquisitions, and spinoffs has been implemented in Cyprus. Consequently, mergers, divisions, transfers of assets, and exchanges of shares can be affected without the imposition of income tax. In addition, the losses of the target company may be transferred to the acquiring company provided that both companies are Cypriot tax residents and certain conditions are met.

The scope of the exemption is broad. Gains resulting from the exchange of shares in a merger or reorganization will not be subject to tax. When immovable property is included in the reorganization, capital gains on the transfer will not be subject to capital gains tax. No land transfer fees will be payable on the transfer of immovable property, 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.

*“Under the current provisions of the law, group loss relief can only be given for losses incurred by Cyprus-resident companies.”*

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.

## NEW TRANSFER PRICING REGULATIONS

Circular No. 3, which was issued in 2017, introduced detailed transfer pricing rules concerning intragroup back-to-back financing arrangements. The rules also apply to interest-free or interest-bearing loans to related parties when such loans originate from other related parties, banks, or other third parties. Loans from the company's own funds to related parties that are not part of a back-to-back arrangement are not subject to Circular No. 3.

Under current legislation, the Tax Commissioner has the right to adjust the value of transactions between related parties when not carried out on an arm's length basis. In the case of an adjustment increasing the income of one party to a related party transaction, a corresponding deduction should be given to the other party as part of a correlative adjustment process.

As with operations carried on in other E.U. Member States, companies operating or maintaining a permanent establishment in Europe must take steps to demonstrate the substance of Cypriot operations in establishing its transfer pricing policies. Appropriate steps include the following:

- In the case of loans, determining whether the lending company in Cyprus has borrowed under intercompany loan arrangements in order to fund a loan to an affiliate
- For other intercompany transactions, performing a functional analysis that is compliant with international standards as part of an annual transfer pricing study, meaning that the amount paid to the affiliate in Cyprus is commensurate with the value of the goods or services provided by the affiliate in Cyprus
- Assessing whether the Cypriot company meets the minimum criteria in order for economic substance to be recognized

For economic substance to apply, the Cypriot company must maintain a physical presence in Cyprus, including an office and staff that has appropriate qualifications. The number of board and shareholders' meetings that are held in Cyprus is another factor to consider and will now be strictly scrutinized. The goal is to have both (i) effective management and control of daily operations and (ii) overall management and control over the business conducted by personnel in Cyprus that are overseen by an active board of directors in Cyprus. General intercompany transfer pricing rules are discussed below in **Other Taxes**.

Circular No. 2017/4 issued on March 22, 2017 states that if an income statement is submitted to the tax department that records the granting of an 80% deduction according to sections 9(1)(e) and 9(1)(k) of the I.T.L. regarding the embedded income of an I.P. asset, the taxpayers return should be based on a transfer pricing study of intra-group transactions which supports the level of incorporated income. The

transfer pricing study should be submitted to the tax department if requested and should be prepared according to the methodologies of the O.E.C.D. Transfer Pricing Guidelines as adopted by the O.E.C.D. on May 23, 2016.

## **D.A.C.6 IMPLEMENTATION IN CYPRUS**

As a member of the E.U., Cyprus is subject to the same obligation as all other E.U. states to implement the Directives on Administrative Cooperation (“D.A.C.”) including D.A.C.6, and the Cypriot law implementing D.A.C.6 was passed March 18, 2021.

### **Reporting Deadlines**

The new submission deadline for D.A.C.6 filings to avoid administrative fines for late submission was extended to January 31, 2022 for the following cases:

- Reportable cross-border arrangements carried out between June 25, 2018 and June 30, 2020 that had to be reported by the February 28, 2021
- Reportable cross-border arrangements carried out between July 1, 2020 and December 31, 2020 that had to be reported by January 2021
- Reportable cross-border arrangements made between January 1, 2021 and January 1, 2022 that had to be submitted within 30 days from whichever occurred first of (i) the date they were made available for implementation, (ii) the date they were ready for implementation, or (iii) the first step in the implementation was taken
- Reportable cross-border arrangements for which secondary intermediaries (i) provided aid, assistance, or advice between January 1, 2021 and January 1, 2022 and (ii) had to submit information within 30 days beginning on the day after they provided aid, assistance, or advice

### **General Considerations**

The Ministry of Finance (“M.O.F.”) is aware that the scope of D.A.C.6 reporting obligations is broad and that it may capture arrangements that arise for commercial reasons more than for tax planning reasons. Consequently, the M.O.F.’s view on the Main Benefit Test (“M.B.T.”) is to compare the value of (i) tax advantages against (ii) other benefits and considerations on a case-by-case basis.

The Cypriot Tax Department defines tax benefit as any of the following advantages:

- The grant of relief or an increase in previously granted relief on tax
- Avoiding tax or reduction of tax
- Deferral of tax payments
- Avoidance of an obligation to withhold tax

The cardinal element of the proposed law is that the tax advantage reported under D.A.C.6 must be seated in the E.U. This means that an arrangement resulting in a tax benefit which affects only the tax base of a non-E.U. jurisdiction does not fall within the M.B.T.

*“... the reporting obligation in Cyprus will include targeting and capturing potentially aggressive tax planning arrangements resulting in tax base erosion of one or more E.U. Member States.”*

Ultimate beneficial owners of Cypriot companies are monitored in existing compliance rules. If any individual who is a tax resident of a Member State of the E.U. secures tax treatment in Cyprus that adversely affects the tax base of that E.U. Member State, information on that cross-border arrangement (“C.B.A.”) will be captured by the law and will be reportable.

The objectives of the M.O.F. are identical to those of the E.U. Consequently, the reporting obligation in Cyprus will include targeting and capturing potentially aggressive tax planning arrangements resulting in tax base erosion of one or more E.U. Member States.

### **Continued Application of Other Directives**

In addition to D.A.C.6, the Cypriot Government will continue to adhere to all previous directives on administrative cooperation in the field of taxation. These include the following:

- Targeting attempts at circumventing mandatory automatic exchanges of financial information (such as C.R.S.)
- Exchanges of information on cross border tax rulings
- Country-by-country reporting
- Facilitating access to anti-money laundering information by tax authorities

Regarding reportable arrangements to be included in D.A.C.6, the M.O.F. has adopted the minimum standards under which D.A.C.6 reporting will not be required for local arrangements and for arrangements with non-E.U. states where the tax base of an E.U. Member State is not affected adversely.

The internal taxes that will be addressed by the Cypriot legislation include only the Income Tax, the Special Defense Tax, and the Capital Gains Tax. No other direct or indirect taxes are covered by the proposed law. Penalties for noncompliance with various reporting obligations may not exceed €20,000 per reportable C.B.A.

### **Basics Adopted by Cyprus**

The basic provisions addressed by the legislation and enacted are listed below.

#### **The M.B.T. and the Hallmarks Falling Within the M.B.T**

This includes hallmarks falling into Categories A and B, as well as certain categories falling into Category C. These are the following:

- **A. Generic Hallmarks**
  - A1. Confidentiality
  - A2. Contingent/Success Fees
  - A3. Standardized Documentation

- **B. Specific Hallmarks**
  - B1. Use of Losses
  - B2. Conversion Income into Capital
  - B3. Circular Flows/ Round-Tripping
- **C. Cross Border Transactions**
  - C1. Deductible Payments, Low or No Tax, Tax Exempt and Preferential Regimes

**The Hallmarks Not Requiring a Finding as to the M.B.T.**

These Reportable C.B.A.'s are defined widely. Among other elements, Reportable C.B.A.'s will include the following:

- **C. Cross Border Transactions, continued**
  - C1. Transactions between Cypriot companies and companies and other entities based in E.U. and O.E.C.D. blacklisted countries, and transactions between Cypriot companies and recipients of income who are not tax resident in any country
  - C2. Transactions otherwise resulting in deduction of depreciation on the same asset in multiple jurisdictions
  - C3. Transactions resulting in double taxation relief claimed twice
  - C4. Transfers of assets significantly projected to reduce valuation of the transferor's income stream
- **D. Automatic Exchanges of Information ("A.E.O.I.")**
  - D1. Arrangements which circumvent A.E.O.I. by utilizing jurisdictions that are not regulated or compliant must be reported
- **E. Transfer Pricing**
  - E1. Transfer pricing elements such as exploiting the existence of safe harbor rules
  - E2. Transfer of hard-to-value intangibles in an arrangement
  - E3. Intra-group cross border transactions (less than 50% E.B.I.T. test)

**Definition of Intermediaries**

In general, the Cypriot Government has adopted the definition of an intermediary that is provided by D.A.C.6. Consequently, intermediaries include all persons devising, drafting, advising on, and marketing tax planning arrangements. Also included are persons that assist in implementing those arrangements.

Exemption has been granted to those providing tax compliance and auditing services. Lawyers have also been exempted due to professional confidentiality regulations in Cyprus, but the same conditions apply as with other E.U. Member States.

## **Further Cyprus Considerations**

Cyprus adopted the position in the Law, that E.U. approved tax schemes implemented in Cyprus such as the I.P. Box regime, Tonnage Tax regime in the shipping industry, and the N.I.D. do not fall within the proposed D.A.C.6 law.

Regarding Hallmarks that are applicable without reference to the M.B.T., the Cypriot position is that most of these will only be applicable provided the arrangements in question are with legal entities based in countries on the E.U. and/or O.E.C.D. Noncooperative Jurisdiction lists. Cyprus strictly implements rules attacking transactions with companies based in such listed jurisdictions.

Cyprus has adopted the common goal of E.U. tax authorities to react proactively and decisively when tax rules may facilitate aggressive and harmful tax practices.

The M.O.F. has adopted a policy that ensures access to a level playing field for large and small taxpayers.

## **U.B.O. REGISTERS**

The Anti-Money Laundering Law (“A.M.L.”) amending the Cyprus A.M.L. legislation with the implementation of the E.U. Directive 2018/843 specifically on the Ultimate Beneficial Owners (“U.B.O.”) registers was enacted on 23/02/21 and therefore Cyprus has now introduced the UBO registers. The Registrar of Companies has announced that entities can submit the information to the U.B.O. register in electronic form via the online portal. The submission period has been extended until July 31, 2022.

### **Multiple Registers**

The created registers are as follows:

- Register of the Crypto Assets Service Providers – kept by Cyprus Securities and Exchange Commission
- Register of the Electronic Registry of Bank accounts, Payment Accounts and safe Boxes – kept by the Central Bank of Cyprus
- Beneficial Ownership Register of Companies and other legal entities – kept by the Department of the Registrar of Companies and Official Receiver
- Beneficial Ownership Register of Express Trusts and Similar arrangements – kept by Cyprus Securities and Exchange Commission
- Beneficial Ownership Register of legal bodies (foundations, clubs, unions etc.) – kept by the General Commissioner

The one that concerns businesses is the Beneficial Ownership Register of Companies and other legal entities which is to be maintained by the Registrar of Companies.

### **Definition of Beneficial Owner**

According to Guidance issued by the Registrar of Companies, the beneficial owner” means any natural person or persons who ultimately own or control the company

and the natural person or persons on whose behalf a transaction or activity is being conducted.

In practice U.B.O.'s are all those persons who own 25%+1 share of the issued share capital of a company. If such a U.B.O. cannot be determined, then the decisive factor is determining the physical person or persons who exercise effective control over the company.

The above is the very basic definition on reportable U.B.O.s but further criteria exist on a case-by-case basis.

### **Information to be Filed at the Registrar of Companies**

#### **Legal Entities**

- Name, surname, month and year of birth, nationality, and residential address
- Nature and extent of the beneficial interest held directly or indirectly by each beneficial owner, including percentage of shares, voting rights
- Identification document number indicating the type of document and the country of document issuance (Identity card or passport depending on the specific facts)
- Date on which the natural person was entered in the register as beneficial owner
- Date of changes in the particulars of the natural person or the date on which the natural person ceased to be a beneficial owner

#### **Trusts**

- Name
- Registration number, if any
- Jurisdiction
- Nature and percentage of beneficial interest
- Date when it became a U.B.O.
- Date of any changes and/or cancellation of shareholding

#### **Internal Register**

All professionals/service providers must also maintain internal registers separately with all of the data as mentioned above in the same format as filed at the Registrar of Companies in addition to the usual legally required Due Diligence/Know Your Client files of each client.

The above obligation is two pronged as it covers both the service providers as well as the Directors/Secretary of each company.



### Penalties

Penalties include €200 fixed fees plus €100 per additional day of noncompliance, with a cap of €20,000 per company.

### Access to Information

The following persons and officials have access to the information in the registers:

- Competent governmental supervisory authorities have access without notifying the entity.
- Responsible entities within the process of conducting statutory due diligence will have restricted access to the following:
  - Name
  - Month and year of birth
  - Nationality
  - Country of residence
  - Nature and extent of interest
- The general public has restricted access to the same information as obliged entities.

## **SPECIFIC INCOME TAX BENEFITS**

Certain types of income that may be subject to favorable tax treatments are discussed in the following sections.

### **Shipping**

Under the reciprocal exemption provisions, in the case of a shipping business, profits or benefits arising from the business of operating and managing ships benefit from exemption from income tax if they are carried on by a person who is not a resident of Cyprus, provided that the Cypriot Minister of Finance is satisfied that there is an equivalent exemption from income tax granted by the country in which such person is resident to persons resident in Cyprus who carry similar business in that other country.

The Merchant Shipping Law of 2020 provides for an increase in the tonnage tax applicable to qualifying ship owning and ship management companies. The resulting tax is substantially lower than the annual corporate income tax of 12.5%. The amended law is in line with the E.U. Commission's approval of the tonnage tax which is in line with E.U. Guidelines on State Aid to the maritime transport industry.

The key changes to the law are as follows:

- The Merchant Shipping Law has been extended for a further ten years until December 2029.



- The definition of the term “maritime transport” has been amended to include ancillary activities to maritime transport provided certain qualifying conditions are met.
- The term “Qualifying Ship” has been further defined with the addition of lists of both qualifying and excluded vessels.
- Bareboat charters within the same group, meaning intra-group transactions, are now eligible under tonnage tax.
- The new law provides for a further reduction in tonnage tax by 30% for E.U./E.E.A. vessels which use methods for environmental preservation of the marine environment and reduction of effects on climate change.
- The Law further extends tax benefits to sea fare of E.U. and E.E.A. registered ships.

### **Intellectual Property**

Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the effective rate of 10% of the amounts paid, subject to treaty provisions. Withholding tax is imposed on film rental income derived by a nonresident with Cyprus source income at the rate of 5% subject to treaty provisions. However, the E.U. Royalties Directive applies in the case of film rentals.

Royalties paid for the use of I.P. rights outside Cyprus are not subject to withholding tax.

Additionally, 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 intangible income that is reflected in the sale of inventor or other assets.

### Qualifying Expenditures

A qualifying expenditure is the sum of total research and development costs incurred in any tax year, wholly and exclusively for the development, improvement, or creation of qualifying intangible assets, the costs of which are directly related to the qualifying intangible assets.

### 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 at **Special Contribution for the Defense of the Republic**. According to the I.T.L., profit from the sale of so-called titles is tax exempt. In Tax Circular No. 2008/13 dated December 17, 2008, amended by Circular No. 2009/6 dated May 29, 2009, the Cypriot tax authorities gave a list of investment products that constitute titles, the most important of which include the following:

- Ordinary shares
- Founder's shares
- Preference shares
- Options on titles
- Debentures

- Bonds
- Short positions on titles

Dividends paid into a Cypriot holding company are exempt from income tax, provided that hybrid rules do not apply (see **Anti-Avoidance Provisions for Hybrid Instruments and Artificial Transactions for Dividends**).

Furthermore, no withholding tax is payable when dividends are paid by a Cypriot holding company to its nonresident shareholders. However, under a recent amendment of the Special Defense Contribution law, when a nonresident company is situated in a jurisdiction included in the list of jurisdictions that have been assessed by E.U. Member States collectively as noncooperative for tax purposes, or if it is incorporated or registered in such a jurisdiction and is not tax resident in another Member State not included in that list, and it receives any dividends from a company resident in Cyprus, a 17% withholding tax has to be withheld from the amount of the dividend.

The combination of an exemption for share gains and an absence of tax on dividend income received or paid by a Cypriot holding company likely accounts for the notable increase in the number of nonresident-owned holding companies in Cyprus since its accession to the E.U.

Nonetheless, changes to the P.S.D. will affect the use of Cyprus as a holding company jurisdiction for other corporations based in other E.U. countries. The choice of Cyprus as the location for a group holding company must reflect valid commercial decisions and must not have been adopted for improper tax planning purposes. Where these facts are not demonstrated, other E.U. Member States can treat Cypriot holding companies as look-through entities when the substance and activities tests are not satisfied.

Additionally, a unilateral tax credit is allowed in Cyprus for taxes withheld or paid in other countries where no bilateral agreement or double tax treaty is in force.

## LOAN INTEREST

The 9% notional interest on loans or other financial facilities has been eliminated, but if 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.

*“Nonetheless, changes to the P.S.D. will affect the use of Cyprus as a holding company jurisdiction for other corporations based in other E.U. countries.”*

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 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.

## **SPECIAL CONTRIBUTION FOR THE DEFENSE OF THE REPUBLIC**

The second revenue raising measure in Cyprus is the Special Defense Levy. It is a separate income tax imposed on certain dividends and interest.

### **Scope of Levy**

The Special Defense Levy on interest income from investments has 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.

Under prior law, individual residents of Cyprus were eligible for the reduced tax rate of 3% on interest received or credited from corporate bonds, savings certificates, development stocks of the Republic of Cyprus, provident funds, and social insurance funds. The reduced rate of tax was not available for companies, corporate bodies, or retirement funds.

Effective June 8, 2022, both individuals and the eligible companies can benefit from the reduced rate of tax on interest income received or credited from government savings certificates and development bonds and interest from corporate bonds of listed entities, provided that the interest does not accrue from the ordinary conduct of their business activity. 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 company are also exempt if (i) the investment income of the nonresident company is less than 50% of its total income or (ii) the foreign tax burden is not substantially lower than the tax burden in Cyprus. The term “substantially lower” is not defined within Cypriot law and is, therefore, left to the discretion of the tax authorities.

### **Penalties**

New amendments impose much higher and stricter penalties for noncompliance with the provisions of the Special Contribution for the Defense of the Republic.

## **OTHER TAXES**

### **Capital Gains Tax**

#### **Prior Law**

Capital gains tax is not applicable to profits earned from the sale of securities but is applicable to real estate sales within Cyprus.

#### **Current Law**

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 current law, the scope of capital gains tax is expanded. 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 Cypriot company.

#### **Thin Capitalization Rules**

Cypriot tax law does not contain specific thin capitalization or transfer pricing rules. Nonetheless, transaction values in related-party transactions should be based on the “arm’s length principle.”

## **ARM’S LENGTH TRANSFER PRICING**

Section 33 of the tax law provides specific rules to address business structures where

- 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 the businesses differ substantially from those that would exist between independent businesses.

Under these circumstances, any profits that would have accrued to one of the businesses in the absence of these special conditions may be included in the profits of that business and be taxed accordingly.

This provision allows the Inland Revenue Department to adjust the profits of a resident company or other person for income tax purposes where it is of the opinion that the Cyprus profits have been understated because of the special relationship between the Cyprus-resident person and the other party to a transaction.

## TAX REGISTRATION PROVISIONS

Regarding the obligation to register for a Tax Identification Code (“T.I.C.”) in Cyprus, although a company should register itself with the Cyprus Tax Authorities, a legal framework did not previously exist for such registration or for noncompliance penalties.

Now, a company is required to submit the relevant return and obtain a T.I.C. within 60 days of the date of its incorporation. Failure to comply will now result in heavy fines.

## EXCHANGE OF INFORMATION AND BANK CONFIDENTIALITY RULES

Cyprus is one of the “Early Adopters” of the Common Reporting Standard (“C.R.S.”). 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 affect an automatic exchange of information through the Central Bank of Cyprus with all other jurisdictions that are signatories of the C.R.S. convention. Banks have already introduced new forms, which require the provision of the tax identification numbers in the home country of ultimate beneficial owners (“U.B.O.’s”).

Cyprus is a signatory of the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This is a multilateral agreement to exchange information and provide assistance on the basis of inquiries from one signatory state to another.

Consequently, if and when the Cyprus Tax Authorities receive an inquiry from the tax authority of another signatory state, Cyprus is obliged to provide information without resorting to the procedure described below, so long as certain conditions of the local legislation are satisfied. Fishing expeditions will not be permitted.

For inquiries not related to the C.R.S., the Director of Inland Revenue (the “Director”) retains the right to request that a bank provide information it possesses in relation to any existing or closed bank account of a person under investigation within a period of seven years preceding the date of the request. Prior to making such a request, the Director must obtain written consent from the Attorney General (“A.G.”) and furnish a relevant written notice to the person under investigation with.

The Director must inform the A.G. of the tax purpose and the reasons for which the information is requested. In order to obtain consent from the A.G., the Director should apply directly to the A.G. and furnish both the A.G. and the bank with all of the following information:

*“Now, a company is required to submit the relevant return and obtain a T.I.C. within 60 days of the date of its incorporation. Failure to comply will now result in heavy fines.”*



- The identity of the person under examination
- A description of the information requested, including the nature and manner in which the Director wishes to receive the information from the bank
- The reasons which lead to the belief that the requested information is in the custody of the bank
- The (specific and reasoned) period of time for which the information is requested
- A declaration that the Director has exhausted all means at his/her disposal to obtain the requested information, except where resorting to such means would have imposed an undue burden

The Director must inform the person under investigation of the written consent, or the refusal of such consent, by the A.G. as soon as this information is made available.

## **PROVISION OF INFORMATION BY CIVIL SERVANTS**

The confidentiality bar on civil servants is now removed, and civil servants are now under the obligation to reveal to the tax authorities, upon request, any information they may have on taxpayers.

## **BOOKKEEPING AND FIELD AUDITS**

Following the provision of a reasonable notice to the interested party during a field audit, the Director is entitled to enter and inspect any business premises, building premises, or rooms (during business hours), except residential dwellings, including any goods and documents found in them.

## **MORE STRINGENT REQUIREMENTS FROM THE E.U. AND OTHER JURISDICTIONS**

Various E.U. Member States and other jurisdictions now require more detailed explanations from clients using private Cypriot companies within their structures. Such disclosures include the length of time shares are held, copies of transaction documents, confirmation from the board of directors that the Cypriot company is managed and controlled in Cyprus, proof of the appropriate qualifications and experience of the directors, and evidence of an actual physical presence in Cyprus.

With planning, proper record keeping, and the adoption of rules regarding economic substance, corporate residents of Cyprus have successfully claimed treaty benefits from foreign tax authorities.



# DOUBLE TAX TREATIES

## In General

Cyprus has developed an extensive network of double tax treaties that offer excellent opportunities for international tax planning for a wide range of businesses. Set out below is the table of jurisdictions.<sup>1</sup>

Andorra	Finland	Lebanon	Seychelles
Armenia	France	Lithuania	Singapore
Austria	Georgia	Luxembourg	Slovakia
Bahrain	Germany	Macedonia	Slovenia
Barbados	Greece	Malta	South Africa
Belarus	Guernsey	Mauritius	Spain
Belgium	Hungary	Moldova	Sweden
Bosnia & Herzegovina	Iceland	Montenegro	Switzerland
Bulgaria	India	Norway	Syria
Canada	Iran	Poland	Tajikistan
China	Ireland	Portugal	Thailand
C.I.S.	Italy	Qatar	Turkmenistan
Czech Republic	Jersey	Romania	Ukraine
Denmark	Kazakhstan	Russia	U.A.E.
Egypt	Kuwait	San Marino	U.K.
Estonia	Kyrgyzstan	Saudi Arabia	U.S.A.
Ethiopia	Latvia	Serbia	

## Cyprus-U.K. Income Tax Treaty

A double tax treaty between Cyprus and the U.K. took effect on January 1, 2019, replacing the treaty of 1974. The treaty provides for zero withholding taxes on dividends, as long as the recipient is the beneficial owner of the income. The same will also apply to withholding taxes on interest and royalty payments. Gains from the sale of real estate owned by a company will be taxed in the country where the property is located (except for shares of companies traded on a stock exchange).

In determining the tax residency of a company that qualifies as a tax resident in both countries under their respective domestic tax laws, the competent authorities will take into account the following factors:

- The place where the senior management of the company is carried out
- The place where the meetings of the board of directors or equivalent body are held
- The place where the company's headquarters are located

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<sup>1</sup> The treaty concluded between Cyprus and the former U.S.S.R. is applicable to Azerbaijan, Uzbekistan, and Republics of the Commonwealth of Independent States ("C.I.S.") until such time they wish to abrogate the treaty.

- The extent and nature of the company's economic nexus in each country
- Whether determining that the company is a resident of one country but not of the other for the purposes of the tax treaty would carry the risk of an improper use of the treaty or inappropriate application of the domestic law of either country

As expected, a limitation of benefits clause has been inserted into the new tax treaty based on the P.P.T. The clause provides that no benefit will be granted under the treaty with respect to an item of income or a capital gain if it is reasonable to conclude, having considered all relevant facts and circumstances, that obtaining the benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in such benefit.

## THE B.E.P.S. PROJECT – IMPLICATIONS FOR CYPRUS

As previously noted, the main tax provisions relating to Cypriot holding companies have recently been revised in light of E.U. directives and O.E.C.D. recommendations under the B.E.P.S. Project. The B.E.P.S. Project contains 15 specific actions. The impact of these actions on Cypriot tax law is detailed below.

### **B.E.P.S. Action 2 (Hybrid Mismatches)**

The effects of B.E.P.S. Action 2 have been discussed above, in **Hybrid Mismatch Rules**.

### **B.E.P.S. Action 3 (Effective C.F.C. Rules)**

C.F.C. rules have now been introduced. The rules are discussed above in **Controlled Foreign Company (“C.F.C.”) Rules**.

### **B.E.P.S. Action 4 (Interest Deductions)**

B.E.P.S. Action 4 will likely affect Cypriot companies receiving interest income when the jurisdiction of residence of the debtor company introduces measures disallowing deductions for interest expense. In addition, Cyprus has adopted a ceiling on interest expense deductions based on E.B.I.T.D.A. This is discussed in **Cap on Interest Expense**, above. It has also enacted an N.I.D. provision that de-emphasizes overly aggressive debt structures. See the discussion in **Notional Interest Deduction (“N.I.D.”) on Equity**, above.

### **B.E.P.S. Actions 5 (Transparency and Substance)**

As previously discussed in **Intellectual Property**, the I.P. Box regime in Cyprus has become fully compliant with O.E.C.D. Guidelines with the adoption of the “nexus approach.” Intangible assets must be developed in Cyprus in order to claim tax benefits. Benefits afforded under the prior regime were phased out in 2021.

With the introduction of the nexus approach, it will be difficult for many international businesses to continue to take advantage of the Cypriot I.P. Box regime beyond the expiration of the grandfather period at the end of the year 2021. B.E.P.S. Action 6 (Inappropriate Treaty Benefits)

Cyprus has signed the M.L.I., and regarding access to treaty benefits has chosen the P.P.T. for the limitation of benefits (“L.O.B.”) provision.

An L.O.B. provision will now be included in new treaties concluded by Cyprus. The provision will deny treaty benefits to structures in which the Cypriot company does not maintain sufficient contact with or substance in Cyprus.

Cyprus intends to amend its existing double tax treaties to include an L.O.B. provision. For example, the new Cyprus-U.K. tax treaty provides for a limitation of benefits as discussed in **Double Tax Treaties**.

So far, structures under which income is reduced by the 80% notional interest deduction have withstood scrutiny. However, several E.U. Member States have eliminated the provision.

Action Item 6 is likely to result in a considerable number of new treaty provisions. It is likely that Article 3 of a new model treaty will include a definition of “special tax regime” that provides a preferential tax rate for specific items of income, including a notional interest deduction. New provisions will likely be included in Articles 11, 12, and 21 of the O.E.C.D. Model Income Tax Treaty to deny lower treaty withholding tax rates on interest, royalties, or other income when a recipient benefits from low-tax regimes.

#### **B.E.P.S. Action 10 (Arm’s Length Transfer Pricing – Profit Split Method)**

Cypriot companies are often used to provide administrative services to 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 (Transfer Pricing Documentation)**

On December 30, 2016, Order No. 401/2016 was issued by the Ministry of Finance of Cyprus adopting the provisions for Country-by-Country (“C.b.C.”) Reporting.

Every ultimate parent company of a multinational group of companies that is tax resident of Cyprus must submit a C.b.C. Report within 15 months of the end of its financial year. The report must include the following information for each country (whether E.U. or non-E.U.) where the group is operating:

- Revenues
- Profits before taxation
- Tax actually paid and tax payable
- Issued share capital
- Accumulated reserves
- Number of employees
- Tangible assets (other than cash or cash equivalents)



An “ultimate parent company” is a company which meets the following criteria:

- The company holds, directly or indirectly, enough share capital in one or more other companies in the multinational group so that it is required to prepare consolidated financial statements in accordance with the accounting principles followed in the country in which it is resident.
- There is no other company in the multinational group that directly or indirectly holds share capital in the first company which would oblige such other company to prepare consolidated financial statements.

Under certain circumstances, a Cypriot tax resident holding company may be obliged to submit the report even if it is not the ultimate holding company.

Groups with gross annual consolidated revenues of less than €750 million are exempt from this obligation.

### **B.E.P.S. Action 15**

Cyprus is a signatory to the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting that is intended to implement a series of tax treaty measures in one fell swoop.

The M.L.I. applies in cases where both states are party to the M.L.I. The M.L.I. will not apply where only one of the contracting states is a party to it. Each signatory country will have the opportunity to express its reservations to any provisions of found in the instrument.

## **COVID-19 MEASURES**

### **Tax-Related Measures**

The following measures were adopted by the government to provide temporary liquidity to businesses in Cyprus:

- Scheduled implementation of additional contributions to the General Healthcare System (“G.H.S.”) were temporarily deferred. Originally planned to take place by the end of March 2020, the implementation date was deferred for two months.
- A temporary two-month deferral of payment of V.A.T. was granted for certain businesses.
- During this period, penalties and late payment interest were not imposed on the deferred payment. The deferral applied to companies with turnover of less than €1 million or where turnover has fallen by more than 25% compared with the same period in 2019. The V.A.T. due amounts can be settled gradually by November 2020.
- A two-month extension was granted to those individuals and companies who were required to submit tax returns by the end of March 2020.
- In an effort to support shipping companies and owners of Cyprus-flagged vessels facing challenges of COVID-19 outbreak, the deadline for payment of

the Cyprus Registry Maintenance Annual Fee and of the tonnage tax for Cyprus-flagged vessels was extended until the end of May 2020. The ordinary deadline was the end of March 2020.

- The annual fees payable by all Cyprus companies to the Registrar of Companies was postponed from end of June 2020 to end of January 2021.

### **Financial Support Measures**

The following measures were adopted by the government to provide temporary financial support to businesses and their employees:

- Businesses that have ceased operations as a result of the restrictions imposed by Government decrees and as a result suffered a decline in their turnover of 80% or more are entitled to register under the Special Scheme for Full Suspension of Operations. Under the relief, the government pays 60% of the customary salaries of employees. To qualify for the benefit, companies must not have laid off any staff since the beginning of March 2020. The relief covers three months and a fourth is month is available based on a continued downturn in the economy.
- Businesses that have not terminated their activities, but which suffered a reduction in their turnover by more than 25% over a period of three months in comparison with the same period in 2019, are eligible to participate in the Special Scheme for Partial Suspension of Operations. Again, the government pays 60% of the customary salaries of employees. The relief covers three months and a fourth is month is available based on a continued downturn in the economy.
- Interest and principal repayments on loans granted or purchased by financial institutions are suspended until the end of 2020.
- Businesses affected by COVID-19 measures have been granted relief in the form of a lump sum calculated in accordance with the number of employees of each company.
- To support tenants, Cyprus has introduced a tax incentive scheme. According to article 9E of the amended Income Tax Law 58 (I) 2020, landlords who lease their real estate to individuals or legal entities were granted a tax credit equal to 50% of the rent reduction provided that the monthly reduction is not more than 50% or less than 30%. The monthly rent reduction concerns a maximum period of three months.

***“Interest and principal repayments on loans granted or purchased by financial institutions are suspended until the end of 2020.”***

# MALTA

**Author**  
Dr. Stefan P. Gauci  
Malta

## GENERAL OVERVIEW OF BUSINESS FORMS AND RESPONSIBILITIES

### Forms of Business

Malta is distinctive for its hybrid body of law, which blends traditional civil law and U.K. common law principles as subsequently refined by E.U. regulations and directives following its accession in 2004. The result is a unique body of pragmatic law with international application.

The Companies Act envisages three forms of commercial arrangements as vehicles for conducting business: the partnership *en nom collectif*, the partnership *en commandite*, and the limited liability company.<sup>1</sup> Each has its own particular features and advantages. The first two arrangements have decreased in popularity and have been largely replaced by the limited liability company, which is made attractive by the main features of (i) the limited liability of the shareholders<sup>2</sup> and (ii) the separate juridical personality that the limited liability company enjoys.

Generally, the limited liability company – whether private exempt or private non-exempt, single-member or public – is the vehicle for conducting any kind of business activity without territorial limitation.

In addition, Maltese law allows for the increased use of the S.I.C.A.V. and the I.N.V.C.O. as the more specific form of limited liability company undertaking the provision of particular regulated services within the financial services industry:

- S.I.C.A.V. incorporated cell companies and recognized incorporated cell companies have been used in connection with structuring multi-class or multi-fund professional investment funds.
- The insurance sector regularly uses the protected cell company and the incorporated cell company as vehicles to conduct insurance and reinsurance business.

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<sup>1</sup> Since joining the E.U., Maltese company law offers a fourth type of vehicle, the European Economic Interest Grouping (“E.E.I.G.”), which has very particular and special features compared to traditional commercial partnerships. Only 47 entities have been incorporated as E.E.I.G.’s under Maltese law between 2008 and 2019. There were no new registrations of E.E.I.G.’s in 2020 and thereafter, with only 45 active E.E.I.G.’s at the time of writing.

<sup>2</sup> Shareholders’ limitation of liability is not absolute. The liability is limited to the amount of the share-capital that is still unpaid by the shareholder in favor of the limited liability company. The corporate veil may be pierced by the courts of competent jurisdiction in specific cases, such as fraudulent trading.

- Securitization cell companies have become increasingly common. 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 by the board of directors of the securitization company or by holders of special mandates to manage and administer the securitization transaction executed by a particular cell.
- Shipping and aviation cell companies.

### **Capital Contribution Taxes**

A company is incorporated in accordance with the provisions of the Companies Act by registering its memorandum and articles of association with the Malta Business Registry. Maltese law does not prescribe any capital taxes upon incorporation, but does provide for a company registration fee, payable on the extent of the authorized share capital of the company in terms of applicable subsidiary legislation.<sup>3</sup> The fee ranges from a minimum of €100 (on the basis an authorized share capital not exceeding €1,500 or equivalent in any other currency) to a maximum of €1,900 when submitted electronically.<sup>4</sup>

In order to maintain corporate good standing, the directors and company secretary 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 €85 to €1,200, depending on the extent of the company's authorized share capital.<sup>5</sup>

Simultaneously with the company's annual return, the directors and secretary of the company have an obligation to submit an Annual Confirmation B.O. form in compliance with the Companies Act (Register of Beneficial Owners) Regulations (the "B.O. Regulations"). The form is required in specific circumstances as confirmation of the identity of the ultimate beneficial owners of the company, thereby ensuring that both the company's register of beneficial owners as well as the Register of Beneficial Owners maintained by the Malta Business Registry are properly and accurately updated on a regular basis. Likewise, it is mandatory that any changes to the beneficial ownership of the company during the course of the year must be reported to the Malta Business Registry within statutory deadlines.

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<sup>3</sup> One ought to note that Maltese company legislation is heavily influenced by English company law; hence the inherited concept of authorized and issued share capital (a distinction that might be alien to other jurisdictions, especially those based on continental law).

<sup>4</sup> Higher registration fees ranging between €245 (on the basis of an authorized share capital, not exceeding €1,500 or equivalent in other currency) and €2,250 are applicable if the incorporation documents are submitted manually.

<sup>5</sup> Higher registration fees ranging between €100 (on the basis of an authorised share capital not exceeding €1,500 or equivalent in other currency) and €1,400 are applicable if the annual return is submitted manually.

*“The directors of a Maltese company are personally responsible for the company’s compliance with applicable legislation, and, in particular, compliance with Maltese tax law. . .”*

The importance of compliance with the provisions of the B.O. Regulations should not be underestimated. Hefty penalties or imprisonment (or both penalty *and* imprisonment) may be incurred for late filing of the appropriate forms. Additionally, the Registrar of Companies may seek the striking of a company off the Register of Companies for persistent lack of compliance with the B.O. Regulations. Any assets belonging to companies that are struck off the Register of Companies due to violation of the terms of these regulations will devolve in favor of the Maltese government. Nonetheless, it is possible for the shareholders, or any person that demonstrates a legitimate interest, to seek the restoration of the company to the Register of Companies through a court proceeding, so long as the company is brought into good standing and all penalties have been paid in full.

A similar obligation to maintain a Register of Beneficial Owners is imposed upon the directors and the company secretary by the Cooperation with Other Jurisdictions on Tax Matters Regulations.<sup>6</sup> Other penalties may be imposed for noncompliance.

### **Governance and Responsibilities**

The management of a Maltese company rests with its board of directors. Members of the board may be individuals or corporate entities. Directors are not required to be resident in Malta. However, with respect to companies engaging in licensed activities, such as the provision of investment services, the appointment of Maltese-resident directors 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. Under amendments that were introduced in 2021, the directors of a private limited liability company are now required to provide the Malta Business Registry with a positive written declaration of their acceptance to be appointed to the board of directors; previously, this was only required in the case of public limited liability companies. In this respect, the gap between public and private limited liability companies has been narrowed from a governance perspective.

The directors of a Maltese company are personally responsible for the company’s compliance with applicable legislation, and, in particular, compliance with Maltese tax law; directors of a Maltese registered company are personally liable for both direct and indirect taxes owed by the company. Although court decisions vary, the prevalent view is that the responsibility extends to all directors and officers of a company, including the company secretary and persons occupying managerial positions. Comparable liability is also imposed upon the liquidator of a company that is in the process of being wound up throughout the winding up process.

<sup>6</sup>

S.L. 123.127 of the Laws of Malta



The Consolidated Group (Income Tax) Rules<sup>7</sup> allows a group of companies to submit a single, consolidated tax return covering all the companies within the group. A group of companies must satisfy two out of the following three conditions for forming a “fiscal unit.” The parent company must be directly or indirectly entitled to at least

- 95% of the voting rights in the subsidiary company,
- 95% of the profits available for distribution to the ordinary shareholders of the subsidiary company, and
- 95% of the assets available for distribution to the ordinary shareholders of the subsidiary company upon a winding up.

In such a scenario where a fiscal unit exists, the parent company would be acting as the “principal taxpayer” with respect to any 95% subsidiary within the Group.

Additional personal responsibilities imposed on directors relate to the registration of employment contracts and the fulfillment of monthly and annual social security compliance requirements.

### **Audit Requirements**

In Malta, the preparation of mandatory audited financial statements is regulated by the Companies Act, the Maltese Income Tax Acts,<sup>8</sup> and the Accountancy Profession Act.<sup>9</sup> Financial statements are prepared in accordance with the International Financial Reporting Standards or under Maltese Generally Accepted Accounting Principles, as permitted by the Accountancy Profession Act and subsidiary legislation issued thereunder focusing on small and medium-sized enterprises (“S.M.E.’s”).<sup>10</sup>

Generally, it is the directors’ collective responsibility to maintain proper accounting records for the company, even if the accounting function is outsourced to third parties. This duty is owed by the directors to the shareholders due to the fact that directorship carries with it responsibilities of a fiduciary nature (and therefore the requirement of utmost good faith – *uberrima fide*) to the shareholders. Equally important is the fact that this duty extends to third parties who in good faith have entered into a contractual agreement with the company.

All companies are subject to a mandatory audit of their annual reports and financial statements, regardless of the volume of activities undertaken. It does not matter if a company is inactive, generating no turnover or income. Although entities such as

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<sup>7</sup> Subsidiary Legislation 123.189 of the Laws of Malta.

<sup>8</sup> The Income Tax Act (Chapter 123 of the Laws of Malta) and the Income Tax Management Act (Chapter 372 of the Laws of Malta) are commonly referred to as the Income Tax Acts.

<sup>9</sup> Chapter 281 of the Laws of Malta.

<sup>10</sup> Subsidiary Legislation 281.05 of the Laws of Malta.

stand-alone small companies<sup>11</sup> and small groups<sup>12</sup> of companies are not required to have their financial statements audited under company law, the Income Tax Acts still impose an audit requirement.

As a rule, the Companies Act requires the preparation of consolidated accounts whenever a Maltese company is the parent of a subsidiary, regardless of where the registered offices or principal offices of the subsidiaries are located. Certain exemptions apply to (i) private exempt companies and (ii) single-member companies.

### **Specific Industry Incentives**

The Maltese Aircraft Registry was launched in 2010, building on the success of the Maltese Shipping Registry, which was established in 1973. The Maltese Aircraft Registry continues to increase in its popularity as a sought-after registry, particularly in the sector of smaller jets for private business use. The Maltese government continues to invest resources towards strengthening this sector into one of the pillars of the Maltese financial services industry.

Specific fiscal incentives launched by the Maltese government in various business sectors include tax exemptions for royalty income derived from the exploitation of patents, copyrights, and trademarks registered in the name of a Maltese-resident company. The exemption for royalty companies is part of a government program to transform Malta into an intellectual property hub. The exemption applies to gaming companies operating from a base in Malta.

The Maltese government seeks to attract foreign investment into Malta, especially with respect to companies that may seek to relocate their strategic operations to Malta. Towards this end, Malta offers fiscal incentives to individuals who relocate to Malta for the purposes of employment under a qualifying contract, in eligible offices, held with companies registered under the laws of Malta.<sup>13</sup> This includes a 15% flat rate taxation for eligible individuals whose income is derived from a qualifying contract.

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<sup>11</sup> Pursuant to Article 185(1) of the Companies Act, small companies cannot exceed two of the following thresholds, as reported on their balance sheets: (i) a balance sheet total of €2,562,310.74, (ii) a turnover of €5,124,621.48, and (iii) an average number of employees during the accounting period of 50; and small private companies cannot exceed two of the following thresholds: (i) a balance sheet total of €46,587.47, (ii) a turnover of €93,174.94, and (iii) an average number of employees during the accounting period of 2.

<sup>12</sup> Pursuant to Article 185(1) of the Companies Act, small groups of companies cannot exceed any of the following thresholds: (i) an aggregate balance sheet total of €2,562,310.74 net or €3,074,772.89 gross, (ii) an aggregate turnover of €5,124,621.48 net or €6,149,545.77 gross, and (iii) an aggregate number of employees of 50.

<sup>13</sup> In this respect, one may refer to the Highly Qualified Persons Rules (Subsidiary Legislation 123.126), the Qualifying Employment in Innovation and Creativity (Personal Tax Rules, (Subsidiary Legislation 123.141 of the Laws of Malta), the Qualifying Employment in Aviation (Personal Tax) Rules (Subsidiary Legislation 123.168), and the Qualifying Employment in Maritime Activities and the Servicing of Offshore Oil and Gas Activities (Personal Tax) Rules (Subsidiary Legislation 123.182).



Through Malta Enterprise, fiscal and business assistance is provided to businesses that establish companies or factories on Maltese territory for production activities in sector-specific industries, as well as research and development.

Malta is a center for international credit institutions that operate as limited liability companies registered under the provisions of the Companies Act and licensed under the Maltese Banking Act or the Financial Institutions Act by the M.F.S.A. These entities conduct business across the E.U. and the local legislation is compliant with E.U. directives, including the Markets in Financial Instruments Directives (“M.i.F.I.D.” and “M.i.F.I.D II”), the Markets in Financial Instruments Regulation (“M.i.F.I.R.”), the Alternative Investment Fund Managers Directive (“A.I.F.M.D.”), the European Market Infrastructure Regulations (“E.M.I.R.”), and their variations promulgated from time to time.

The Maltese government has been actively promoting Malta as the “Blockchain Island” for a number of years. Malta has been among the first jurisdictions to enact legislation providing a robust, yet flexible, regulatory framework for distributed ledger technology, cryptocurrencies, and artificial intelligence. The establishment of the Malta Digital Innovation Authority, closely followed by the enactment of the Innovative Technology Arrangements and Services Act and the Virtual Financial Assets Act (“V.F.A.”) towards the end of 2018, and the issuance of the first V.F.A. Licenses by the M.F.S.A. in 2019 paved the way for Maltese companies to enter into this new, fast-growing sector. It is expected that these innovations will continue to support the growth of the Maltese economy in the years to come.

In 2019, the Maltese Government sought to build on the successes achieved with respect to the distributed ledger technology and V.F.A. sectors by putting in motion the design of a national strategy in relation to Artificial Intelligence. A task force has been put together and a national strategy for A.I. in Malta 2030 has been published.

The latest legislative initiative has been in relation to the production of cannabis for medical and research purposes. It is a highly regulated sector, aimed at ensuring the safe production of cannabis in Malta for specific medical and health purposes. The legislation has attracted a great deal of foreign interest in setting up research centers in Malta and is at the forefront of a sector that continues to gain momentum not only in Malta, but also internationally.

### **Effect of COVID-19**

COVID-19 has affected Malta in a very negative manner, as it has in all parts of the world. As a preventive and precautionary measure to minimize the spread of the virus, Malta was in a partial lockdown for almost three months during the course of the second quarter of 2020 and again during the second quarter of 2021 with a number of preventive and safety measures implemented to curtail the spread of the virus in Malta. Most notable of these measures were a number of travel restrictions that had been issued from time to time commensurate with the level of risk at the time. On the local level, non-essential businesses and other hospitality/catering establishments were obliged to remain closed for a number of months. However, with the successful roll out of the vaccinations throughout the population there is additional confidence in the recovery of the Maltese economy, especially the tourism industry.

Throughout the pandemic period, the Maltese government launched several incentives of a social and economic nature aimed at assisting local businesses and

*“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%.”*

stimulating further the tourism sector; from the fiscal perspective, the main measures concerned the deferred payment of social security contributions and V.A.T. payments without incurring any penalties for the months during which the pandemic hit the hardest.

During the third quarter of 2021, most of the restrictions were lifted in a quest towards achieving a level of normality in sensitive sectors such as education, essential businesses, and a number of non-essential businesses, but certain restrictions still persisted in the hospitality and catering sectors. These efforts continued during the fourth quarter of 2021 and the first quarter of 2022. All travel restrictions were lifted in the beginning of the second quarter of 2022 and the financial assistance that had been provided by the government to assist specific businesses in the hotel and catering sectors were not renewed. Compliance with administrative obligations required by fiscal and other applicable legislation is expected to resume in line with the normal statutory deadlines, as a result of the pandemic no longer being such a serious threat and businesses returning to a reasonable level of normality.

### **Taxation of Company Profits**

Unless an exemption from tax or a special fiscal regime applies to a company as a result of industry-specific or license-specific tax incentives under Maltese law, companies registered in Malta are generally taxed at the flat rate of 35%.

However, the Income Tax Acts allow for certain types of income to be taxed separately at the source. Included are (i) bank interest, which may be taxed at the source at the rate of 15% upon an election to that effect by the taxpayer, (ii) investment income, which may be taxed at the rate of 15% at source, and (iii) gains from a real property transfer, which are taxed at source upon publication of the final deed of transfer. In the latter case, the tax is collected, on behalf of the Office of the Commissioner for Revenue, by the Notary Public publishing the deed of transfer.

The tax is levied on the taxable income of a company earned in the fiscal year being assessed, after accounting for deductible expenses that are wholly and exclusively incurred in the production of the income. Losses from prior years may be carried forward to offset the profits of the current year. Capital losses may not offset operating profits. Such losses may be used only to offset capital gains. The Income Tax Acts also allow for the benefit of group loss relief in those circumstances where the applicable criteria are met.

Malta applies the full imputation system of taxation, meaning that tax paid by a company is allowed as a credit when dividends are received by its shareholders.

Upon written request, companies that are in compliance with their tax submission and payment obligations may be furnished with a Fiscal Residence Certificate issued by the Office of the Commissioner for Revenue proving that their residence for tax purposes is Malta and, at the same time, confirming their fiscal good standing in accordance with Maltese law.

## **TAX ACCOUNTING**

Profits generated by a company are allocated to the final taxed account, foreign income account, immovable property account, the Maltese taxed account, or the untaxed account, depending on the revenue streams flowing into the company. The

allocation of profits to these accounts is relevant when considering the distributions made by the company and, in particular, when a shareholder who has received a dividend files an application for a tax refund. Distributions are to be made in the following order of priority:

- Profits allocated to the final tax account
- Profits allocated to the immovable property account
- Distributions from the foreign income account
- Profits allocated to the Maltese taxed account
- Profits allocated to the untaxed account

## MALTESE REFUNDABLE TAX SYSTEM

The Maltese refundable tax system, as approved by the E.U., offers a significant advantage because when a company distributes its profits, all shareholders receiving the dividends are entitled to a refund of the tax paid by the company. Nonresident status is not a relevant factor in determining entitlement to the refund. The amount of the refund depends on the nature of the income and the manner in which the income has been allocated to the different tax accounts. The various types of refunds and the circumstances under which they apply are illustrated hereunder.

### **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.

## EUROPEAN COMPLIANCE

The Maltese system of taxation has been the subject of lengthy and detailed discussions with the European Council and the Director-General for Competition regarding State Aid. It has also been discussed with the E.U. Member States within the Code of Conduct Group, consisting of representatives from the Finance Ministries and tax



authorities of various Member States. The Code of Conduct Group identifies tax measures that are harmful under the Code of Conduct for business taxation. In the report submitted to the Economic and Financial Affairs Council (“E.C.O.F.I.N.”) in November 2016, the Code of Conduct Group concluded that the Maltese tax system is not harmful. Malta was and has consistently been transparent about its tax system: it is aimed at creating an attractive system that provides comparable benefits to domestic and foreign investors.

In addition, the European Council has not brought any cases against Malta related to a violation of the “four freedoms” or the principle of nondiscrimination. Malta has fully implemented and complied with all of the E.U.’s tax directives, which are unanimously approved by the Member States in E.C.O.F.I.N., and the Maltese tax system has not been found to infringe on the E.U.’s State Aid rules.

Globally, Malta has applied all O.E.C.D. initiatives to combat tax evasion, including the directives on mutual assistance between tax authorities, automatic exchanges of information, and the exchange of tax rulings and advance pricing arrangements in the field of transfer pricing. Malta is also an early adopter of the Common Reporting Standards and Country-by-Country Reporting obligations. Under Phase II of the O.E.C.D.’s Peer Reviews, Malta has been classified as “largely compliant” in matters of transparency and exchange of tax information.<sup>14</sup>

In June 2016, together with other Member States in E.C.O.F.I.N., Malta approved the Anti-Tax Avoidance Directive (“A.T.A.D.”). All Member States approved the A.T.A.D. 2 in February 2017. The A.T.A.D. entered into force as part of Malta’s body of law on January 1, 2019 (Subsidiary Legislation 123.187). Specific provisions dealing with exit taxation,<sup>15</sup> controlled foreign company (“C.F.C.”) rules, as well as a general anti-abuse provision, have also been introduced into Maltese law.

In sum, the debate revolves around the morality of setting up companies in a low-tax E.U. jurisdiction. These issues have already been addressed in detail by the E.C.J. in the *Cadbury Schweppes* decision. The E.C.J. held that anti-avoidance provisions such as C.F.C. provisions cannot hinder the fundamental freedom of establishment of the E.U., and that profits of a subsidiary in another Member State with a lower rate of taxation can only be taxed in the country of residence of the parent company if the subsidiary is wholly artificial.

On December 20, 2021, the O.E.C.D. published detailed rules to assist in the implementation of a landmark reform to the international tax system which will ensure multinational enterprises (“M.N.E.’s”) will be subject to a minimum tax rate of 15% from 2023. The Pillar Two model rules provide governments with a precise template for moving forward with the two-pillar solution to address the tax challenges arising from the digitalization and globalization of the economy, agreed to in October 2021 by 137 countries and jurisdictions under the O.E.C.D./G20 Inclusive Framework on B.E.P.S.

The rules define the scope and set out the mechanism for the so-called Global Anti-Base Erosion (“GloBE”) rules under Pillar Two, which will introduce a global minimum corporate tax rate set at 15%. The minimum tax will apply to M.N.E.’s with

<sup>14</sup> The United Kingdom, Germany, the Netherlands, and Italy received comparable clarification.

<sup>15</sup> Entered into force on January 1, 2020.

group revenue above €750 million and is estimated to generate around US\$150 billion in additional global tax revenues annually.

## PARTICIPATION EXEMPTION

Any income or gains derived by a Maltese-registered company from a participation in a company or from the transfer of a company qualifying as a participation is exempt from tax.

With respect to a dividend from a participation in a subsidiary, this exemption applies only when either of the following conditions are satisfied:

- The body of persons in which the participating holding is held satisfies any one of the following conditions:
  - It is a resident of or incorporated in an E.U. Member State.
  - It is subject to foreign tax at a rate of at least 15%.
  - It does not derive more than 50% of its income from passive interest or royalties.
- If none of the above conditions are satisfied, then both of the following conditions must be met in order to qualify for the exemption:
  - The equity holding is not a portfolio investment.<sup>16</sup>
  - The passive interest, or its royalties, have been subject to foreign tax at a rate which is not less than 5%.

An investment qualifies as a participation where any of the following conditions are met:

- A company holds directly 10% or more of the equity of a company whose capital is wholly or partly divided into shares, and the shareholding confers an entitlement to at least 10% of any two of the following:
  - Voting rights
  - Profits available for distribution
  - Assets available to shareholders upon liquidation
- A company is a shareholder in another company (the “target company”) and is entitled, at its option, to acquire the entire balance of the issued and outstanding shares in the other company.
- A company is a shareholder in the target company and holds a right of first refusal over all shares in the target company that are owned by others in the event of a proposed disposal, redemption, or cancellation.

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<sup>16</sup> For this purpose, the holding of shares by a Maltese-resident company in a company not resident in Malta and that derives more than 50% of its income from portfolio investments is itself deemed to be a portfolio investment.

- A company is a shareholder in the target company and is entitled to board participation.<sup>17</sup>
- A company is a shareholder in the target company and the value of its investment is at least €1,164,000 at the time of purchase. The investment must be held for at least 183 consecutive days.
- A company is a shareholder in the target company where the investment was made for the furtherance of its own business and the holding is not maintained for the purposes of a trade.

Gains or profits arising on the transfer of a participating holding derived by a company registered in Malta (the “transferor company”), shall only qualify for the exemption if such gains or profits would have been exempt had the transfer of the holding been made by the beneficial owner of the transferor company. Where there is more than one beneficial owner, and gains or profits made by one or more shareholders thereof would be exempt (the “exempt beneficial owner”) and others would not be exempt, the exemption shall apply to that part of the gain or profit to which the exempt beneficial owner is beneficially entitled.

Under an anti-abuse rule, where the transferor company has claimed the exemption described in the preceding paragraph on the whole or part of the gains or profits, and any person who would not have qualified for the exemption (the “non-qualifying shareholder”) thereafter becomes beneficially entitled to some or all of the gains or profits – or to a larger part thereof than was the case at the time the gains or profits arose – such untaxed gains or profits, or additional part thereof to which the non-qualifying shareholder becomes entitled shall be taxed at the rate referred to in Article 56(6). Such tax shall constitute tax payable by the company in the year of assessment in respect to which such person shall become entitled to such profits, even prior to their distribution.

The participation exemption does not apply to income derived from a participation in a company that is resident for tax purposes in a jurisdiction included in the E.U. list of noncooperative jurisdictions for a minimum period of three months during the year immediately preceding the year of assessment, unless it is proved to the satisfaction of the Commissioner that the company carries on sufficient significant people functions in that jurisdiction that are commensurate with the income realized by the company. Where such three months are consecutive and fall in two subsequent consecutive basis years, the exemption shall not apply in respect to any such income derived in any one of the two years.

## OTHER EXEMPTIONS

Other exemptions apply, the most important of which include the following:

### **Permanent Establishment**

Income or gains derived by a company resident in Malta are exempt from Maltese taxation if attributable to a permanent establishment situated outside of Malta. The exemption covers income from ongoing operations and gain from a sale of the

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<sup>17</sup> To be considered a participation, the right to nominate members of the board of directors should be a majority right.





assets of the permanent establishment. For purposes of the exemption, profits or gains shall be calculated as if the permanent establishment is an independent enterprise operating in similar conditions and at arm's length.<sup>18</sup>

In the case of distributed profits received from a participation by a parent company that is resident in Malta, or a permanent establishment in Malta of a company that is resident in another E.U. Member State, the participation exemption applies only to the extent the distribution is not deductible by the payor.

### **Intellectual Property**

Royalties, advances, and similar income derived from patents, copyrights, or trademarks are exempt from tax in Malta. Profits from exempt income remain exempt at the level of shareholders when distributed by way of a dividend. The exemption continues as dividends are distributed through a chain of shareholders.

## **WITHHOLDING TAXES ON DIVIDENDS DISTRIBUTED**

No withholding taxes are levied on dividend distributions to a nonresident shareholder, provided that the shareholder is not directly or indirectly owned and controlled by, and does not act on behalf of, an individual who is ordinarily resident and domiciled in Malta.

## **WITHHOLDING TAXES ON INTEREST PAID**

No taxes are levied on interest payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the interest is effectively connected therewith. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

## **WITHHOLDING TAXES ON ROYALTIES PAID**

No taxes are levied on royalty payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the royalty payment is effectively connected with that permanent establishment. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

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If, in the opinion of the Commissioner, a series of transactions is effected with the main purpose of reducing the income tax liability of any person through the operation of the permanent establishment exemption, that a person is assessable as if the exemption did not apply. A series of transactions means two or more corresponding or circular transactions carried out by the same person, either directly or indirectly, as the case may be.

## TRANSFERS OF SHARES IN A MALTESE COMPANY

Malta imposes a stamp duty on transfers of shares in a Maltese company. However, an exemption applies to transfers of shares in a Maltese company in which (i) more than 50% of the ordinary share capital, voting rights, and rights to profits are held by persons not resident in Malta or by the trustee of a trust in which all beneficiaries are nonresident with regard to Malta and (ii) ownership or control is not held, directly or indirectly, by persons resident in Malta. No capital gains tax is due on a transfer by nonresidents. The exemptions do not apply if the company owns immovable property in Malta.

Similar exemptions from stamp duty and income tax liability apply when the value of the ownership is shifted from one shareholder to another shareholder by way of the issuance of shares by the company. The value of the ownership is represented by the percentage share capital held or the voting rights held in the company. In terms of Maltese law, these are considered as deemed transfers.

## DOUBLE TAXATION RELIEF

With respect to the Income Tax Acts, relief from double taxation may take one of three forms: (i) treaty relief, (ii) unilateral relief, or (iii) flat rate foreign tax credit.

### **Treaty Relief**

Treaty Relief is available if all the following criteria are satisfied:

- Under the relevant double tax treaty, the foreign tax paid in the other state is allowed as a credit against tax payable in Malta.
- The foreign tax is of a similar character to the tax imposed in Malta.
- The person making the claim is a resident of Malta during the year immediately preceding the year of assessment, and tax is payable on such income.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Malta's double tax treaty network is made up of treaties in force with more than 80 states. These treaties are by and large modeled after the O.E.C.D. Model Convention provisions and treaty interpretations as per the Commentaries. The countries within Malta's double tax treaty network are listed below.

Albania	Finland	Libya	Serbia
Andorra	France	Liechtenstein	Singapore
Armenia	Georgia	Lithuania	Slovakia
Australia	Germany	Luxembourg	Slovenia
Austria	Ghana	Malaysia	South Africa
Azerbaijan	Greece	Mauritius	South Korea

Bahrain	Guernsey	Mexico	Spain
Barbados	Hong Kong	Moldova	Sweden
Belgium	Hungary	Monaco	Switzerland
Botswana	Iceland	Montenegro	Syria
Bulgaria	India	Morocco	Tunisia
Canada	Ireland	Netherlands	Turkey
China	Isle of Man	Norway	Ukraine
Croatia	Israel	Pakistan	U.A.E.
Curaçao	Italy	Poland	U.K.
Cyprus	Jersey	Portugal	U.S.A.
Czech Republic	Jordan	Qatar	Uruguay
Denmark	Kosovo	Romania	Vietnam
Egypt	Kuwait	Russia	
Estonia	Latvia	San Marino	
Ethiopia	Lebanon	Saudi Arabia	

Malta has signed double taxation treaties with Curaçao, Ethiopia, and Ghana, but these have not yet entered into force. The treaties with Bosnia and Herzegovina, Oman, and Thailand are currently in various stages of negotiation.

Malta has signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which automatically amended a number of existing double taxation treaties with regard to exchange of information.<sup>19</sup>

### **Unilateral Relief**

In order to claim unilateral relief, the following conditions must be met:

- Treaty relief is not available to the person making the claim.
- The income in question arises outside of Malta and is subject to tax in the state of its source.
- The foreign tax is of a similar character to the tax imposed in Malta.
- The person entitled to the income is resident in Malta, or is a company registered in Malta for the year immediately preceding the year of assessment, and tax is payable on such income.
- The person making the claim proves to the satisfaction of the Commissioner of Inland Revenue that the foreign income has borne foreign tax and proves the amount of the tax.

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

<sup>19</sup> Affected treaties include the treaties with Albania, Andorra, Australia, Austria, Barbados, Belgium, Canada, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Greece, Guernsey, Hungary, Iceland, India, Ireland, Isle of Man, Israel, Jersey, Jordan, Latvia, Liechtenstein, Lithuania, Luxembourg, Malaysia, Mauritius, the Netherlands, Norway, Pakistan, Portugal, Qatar, Russia, San Marino, Saudi Arabia, Serbia, Singapore, Slovakia, Slovenia, Spain, South Korea, Sweden, Ukraine, the United Kingdom, and Uruguay.

which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

### **Flat Rate Foreign Tax Credit**

The Flat Rate Foreign Tax Credit is available if all the following conditions are met:

- Treaty relief and unilateral relief are not available to the person making the claim.
- Income or gains are received by a company registered in Malta, which includes a Maltese branch of a nonresident company.
- The company is empowered to receive such income or gains.
- The income or gains are allocated to the foreign income account.
- Documentary evidence is made available that is satisfactory to the Commissioner for Revenue that the income or gains are to be allocated to the foreign income account.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the 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.<sup>20</sup> Maltese implementation of the F.A.T.C.A. provisions was published on March 7, 2014.<sup>21</sup> The first exchanges between the two states under the I.G.A. took place in the third quarter of 2015.

Malta is also an active participant in the B.E.P.S. Project. It is a member of the *ad hoc* group of countries mandated by the O.E.C.D. and the G-20 in February 2015 to complete work on B.E.P.S. Malta signed the Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting (the “M.L.I.”) on June 7, 2017. The M.L.I. was transposed in Maltese legislation on April 27, 2018.<sup>22</sup>

Following the implementation of a 2010 protocol amending the Joint Council of Europe/O.E.C.D. Convention on Mutual Administrative Assistance in Tax Matters, Malta ratified the amended convention on May 23, 2013. The Amended Convention was adopted into Maltese law and became effective on September 1, 2013.

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

<sup>20</sup> Malta and the U.S. signed a Model 1 I.G.A. on December 16, 2013.

<sup>21</sup> See Exchange of Information (United States of America) (F.A.T.C.A.) Order, Subsidiary Legislation 123.156.

<sup>22</sup> See Multilateral Convention (Implementing Tax Treaty Measures to Prevent Base Erosion and Profit Shifting) Order, Subsidiary Legislation 12.183.

*“Malta actively participates in initiatives against harmful tax competition, which includes cooperation in foreign tax-related matters.”*

adopted into Maltese law effective July 22, 2011. Following amendments that were made via Council Directive (EU) 2018/822 (“D.A.C.6”), as of 2018 intermediaries and, in certain circumstances, relevant taxpayers became obliged to provide information tax authorities of E.U. Members States relating to reportable cross-border arrangements to.

Council Directive (EU)2021/514 (“D.A.C.7”) extends the E.U. tax transparency rules to digital platforms and introduces an obligation for digital platform operators to provide information on income derived by sellers through their platforms. This Directive enters into force from 2023 onwards. The information collected will be shared with the tax authorities of the concerned Member States with the aim of addressing a lack of tax compliance and the under-declaration of income earned from commercial activities carried out with the intermediation of such digital platforms.

It is expected that the advent of D.A.C.7 may lead to a future proposal for an E.U. Council directive, already styled “D.A.C.8.” The proposal will likely seek to enlarge and widen the exchange of information framework in the field of taxation and include crypto-assets and e-money.

Malta is an early adopter of the Common Reporting Standard and is expected to submit its first report by the end of June 2017, focusing on the financial year ending on December 31, 2016.

Malta signed an Exchange of Information Agreement with Macau (signed on May 30, 2013, but not yet in force). Other agreements already in force include the Bahamas (January 15, 2013), Bermuda (November 5, 2012), the Cayman Islands (April 1, 2014), and Gibraltar (June 12, 2012).

In compliance with the E.U.’s Fourth Anti Money-Laundering Directive,<sup>23</sup> Malta has implemented the Ultimate Beneficial Ownership Register via the enactment of the Companies Act (Register of Beneficial Owners) Regulations (the “B.O. Regulations”).<sup>24</sup> The Ultimate Beneficial Ownership Register is maintained by the Malta Business Registry as a central registry on the national level, whilst the directors of companies have a corresponding obligation to maintain their own corporate beneficial ownership register on an individual corporate basis. Regular inspections are conducted by the Malta Business Registry to ensure that every company is compliant with the requirements of the B.O. Regulations and that there is the level of transparency with respect to beneficial ownership that is demanded by international best practices. Failure to comply with the B.O. Regulations may lead to the imposition of administrative penalties, imprisonment, or both. Persistent noncompliance may lead to the striking of a company off the Registry of Companies with all its assets devolving upon and in favor of the government of Malta. A court process can be initiated by interested parties (primarily the shareholders) to have the company

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<sup>23</sup> See Directive (E.U.) 2015/849 of the European Parliament and of the European Council of May 20, 2015.

<sup>24</sup> See Subsidiary Legislation 386.19. These regulations were enacted as part of wider legislation creating separate Ultimate Beneficial Ownership Registers for the purposes of the Trusts and Trustees Act (Subsidiary Legislation 331.10) and the Civil Code with respect to foundations (Subsidiary Legislation 16.15), all intended to ensure compliance with the provisions of the Fourth and Fifth Anti-Money Laundering Directive.

*“The Rules specifically exclude marketing related I.P. assets such as brands, trademarks and trade names from Qualifying I.P.”*

restored to the Registry of Companies, provided all accrued penalties have been paid by the directors, any aspects of noncompliance have been remedied, and the company has been brought back into good standing.

Under the relevant provisions of the Cooperation with Other Jurisdictions on Tax Matters Regulations, companies are required to maintain a different and separate beneficial ownership register (though largely identical to the beneficial ownership register in terms of the B.O. Regulations). Similarly, inspections by the Office of the Commissioner for Revenue may be conducted for the purpose of ascertaining compliance with these obligations and penalties may be imposed if the company is found to be noncompliant.

The Fifth Anti Money-Laundering Directive has also been implemented and entered into force.

## PATENT BOX REGIME

The Patent Box Regime (Deduction) Rules were introduced in 2019 to provide a basis on which the deduction may be claimed and shall apply in relation to qualifying income derived from qualifying intellectual property (“Qualifying I.P.”) on or after January 1, 2019. Qualifying IP generally comprises the following assets:

- Patents whether issued or pending, provided that where a pending patent is eventually rejected, such patent is deemed to have never constituted Qualifying I.P.
- Assets in respect of which protection rights are granted in terms of national, European or international legislation; utility models; or software protected by copyright under national or international legislation.
- In the case of a small entity (as defined in the Rules), other I.P. assets that are non-obvious, useful, novel and have similar features to patents, provided that certification is obtained by Malta Enterprise.

The Rules specifically exclude marketing related I.P. assets such as brands, trademarks and trade names from Qualifying I.P.

The deduction applies only upon the satisfaction of the following cumulative criteria:

- The research, planning, processing, experimenting, testing, devising, designing, development or similar activities leading to the creation, development, improvement or protection of the Qualifying I.P. is carried out wholly or in part by the Beneficiary, alone or with any other person(s) or in terms of cost sharing arrangements with other persons, whether these are resident in Malta or otherwise.<sup>25</sup>

<sup>25</sup>

Such activities *inter alia* include: (i) functions performed by employees of other enterprises, which employees are acting under specific directions of the Beneficiary (in a manner equivalent to that of employees of such Beneficiary) and (ii) functions carried out through a permanent establishment (including a branch) situated in a jurisdiction other than the jurisdiction of residence of the beneficiary, to the extent that such permanent establishment derives income which is subject to tax in the jurisdiction of residence of the Beneficiary.

- The Beneficiary is the owner, co-owner, or holder of an exclusive license in respect of, the Qualifying I.P.
- The Qualifying I.P. is granted legal protection in at least one jurisdiction.
- The Beneficiary maintains sufficient substance in terms of physical presence, personnel, assets or other relevant indicators in the relevant jurisdiction in respect of the Qualifying I.P.
- Where the Beneficiary is a body of persons, it is empowered to receive such income.
- The request for such deduction is included in the Beneficiary's tax return.

## CONCLUSIONS APPLICABLE TO MALTA

The legal framework in Malta offers several key advantages for those seeking to conduct international business in a sound and reputable jurisdiction.

Maltese transfer pricing rules are relatively flexible, and there are no thin capitalization rules. Several anti-abuse rules are contained in Article 51 of the Income Tax Act and Malta now applies the general anti-abuse provision in the A.T.A.D. designed to combat artificial and fictitious schemes.

The legislation in Malta permits companies to migrate to and from Malta as long as certain minimum requirements are fulfilled. Branches of overseas companies enjoy the same tax treatment applicable to companies incorporated in Malta. Incorporation and winding up procedures are relatively easy and in general quite expeditious.



## About Us

Ruchelman P.L.L.C. is a boutique law firm based in New York City. It was founded in 1989 by an alumnus of a legacy firm that is now Deloitte's.

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*Insights*, the tax journal of Ruchelman P.L.L.C., provides in-depth reporting on the evolving landscape of U.S. and international taxation. It offers complex analysis of current issues, legislative updates, and practical introductions to the tax law from leading tax professionals in their respective countries.

Special features include an annual examination of the use of holding companies in European tax planning and a look at the year in review.

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Architects and Designers Building | 150 East 58th Street, 22nd Floor | New York, New York 10155

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## Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

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Galia Antebi	<a href="mailto:antebi@ruchelaw.com">antebi@ruchelaw.com</a>	+1 212.755.3333 x 113
Nina Krauthamer	<a href="mailto:krauthamer@ruchelaw.com">krauthamer@ruchelaw.com</a>	+1 212.755.3333 x 118
Wooyoung Lee	<a href="mailto:lee@ruchelaw.com">lee@ruchelaw.com</a>	+1 212.755.3333 x 121
Michael Peggs	<a href="mailto:peggs@ruchelaw.com">peggs@ruchelaw.com</a>	+1 212.755.3333 x 232
Simon H. Prisk	<a href="mailto:prisk@ruchelaw.com">prisk@ruchelaw.com</a>	+1 212.755.3333 x 114
Neha Rastogi	<a href="mailto:rastogi@ruchelaw.com">rastogi@ruchelaw.com</a>	+1 212.755.3333 x 131
Stanley C. Ruchelman	<a href="mailto:ruchelman@ruchelaw.com">ruchelman@ruchelaw.com</a>	+1 212.755.3333 x 111

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## Editorial Staff

Stanley C. Ruchelman ..... Editor in Chief  
Francesca York ..... Graphic Designer

### WITH PHOTOS BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.

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