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corporate  
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taxation

# INSIGHTS

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**HOLDING COMPANIES OF EUROPE –  
TAX PLANNING FOR EUROPEAN EXPANSION  
IN A CHANGING LANDSCAPE**

Insights Special Editions



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### About Us

## EDITORS' NOTE

For several years, the summer edition of *Insights* has examined the use of holding companies as part of European tax planning.

Historically, these plans followed a roadmap designed to deconstruct business operations, placing production, financing, and I.P. functions with separate group members in different countries. If the roadmap was carefully followed, European taxes could be driven down in ways that did not result in immediate U.S. taxation under Subpart F.

However, the year 2017 sounded the death knell for old-fashioned cross-border tax planning. By the end of 2017, too many barriers were in place to realistically believe that old planning strategies would still yield benefits.

The first barrier consisted 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 was a never-ending stream of directives issued by the European Commission and proposals by the European Parliament attacking various tax plans involving affiliated companies. Finally, the U.S. enacted the Tax Cuts & Jobs Act (“T.C.J.A.”) in late December 2017, which turned cross-border tax planning on its head. The T.C.J.A. included many changes to U.S. international tax law.

- The scope of the C.F.C. rules in the U.S. was expanded in ways that not even Congress anticipated.
- A dividends received deduction with a low ownership threshold replaced the indirect foreign tax credit.
- Outbound transfers of property for use in an active trade or business conducted outside the U.S. were made fully taxable for a U.S.-based group.
- G.I.L.T.I. provisions were adopted to impose current U.S. tax on a large portion of a C.F.C.’s operating income.

This edition of *Insights* addresses these and other 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. From there, B.E.P.S. provisions applicable on a global basis are addressed, followed by European attacks on illegal State Aid and abusive tax planning within Europe. It concludes with detailed explanations of corporate tax rules in 15 European jurisdictions by recognized experts in the respective countries.

We hope you enjoy this issue.

- The Editors

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# INTRODUCTION

## Author

Stanley C. Ruchelman  
Ruchelman P.L.L.C.  
New York, United States

## 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 over time.
- 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

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

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. 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 Directives of the European Commission ("E.C.").

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

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

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

The foreign tax credit limitation was structured to prevent so-called "cross crediting," under which high taxes on operating income could be used to offset U.S. tax on lightly-taxed investment income. For many years, the foreign tax credit limitation was applied separately with regard to eight different categories, or baskets, of income designed to prevent the absorption of excess foreign tax credits by low-tax foreign-source income. In substance, this eviscerated the benefit of the foreign tax credit when looked at on an overall basis. The problem was eased when the number of foreign tax credit baskets was reduced from eight to two: passive and general.

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<sup>1</sup> Section 904(a) of the Internal Revenue Code of 1986 (hereinafter, the "Code").

*“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.”*

Additionally, the foreign tax credit was reduced for dividends received from foreign corporations that, in the hands of the recipient, benefited from reduced rates of tax in the U.S. The 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) were removed from the numerator and denominator of the foreign tax credit limitation to reflect the reduced tax rate.<sup>2</sup> This treatment reduced the foreign tax credit limitation when a U.S.-resident individual received both qualifying dividends from a foreign corporation and other items of foreign-source income within the same basket that are subject to ordinary tax rates.

As a result 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>3</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>4</sup> Direct tracing of interest expense to income derived from a particular asset was permitted in only limited circumstances<sup>5</sup> involving qualified nonrecourse indebtedness,<sup>6</sup> certain integrated financial transactions,<sup>7</sup> and certain related controlled foreign corporation (“C.F.C.”) indebtedness.<sup>8</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.

The problem was worsened by carryovers of overall foreign loss accounts.<sup>9</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 of 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.

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

<sup>3</sup> Treas. Reg. §§1.861-8 through 17.

<sup>4</sup> Treas. Reg. §§1.861-9T(f)(1) and (g).

<sup>5</sup> Treas. Reg. §1.861-10T(a).

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

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

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

<sup>9</sup> Code §904(f).

## **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>10</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>11</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>12</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 beyond a literal reading of the statute, but are nonetheless deemed to be abusive by the I.R.S. Abuses that have been addressed by the I.R.S. include the following:

- 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>13</sup>

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<sup>10</sup> Code §7874(a)(1).

<sup>11</sup> Code §7874(a)(2)(B).

<sup>12</sup> Code §7878(b).

<sup>13</sup> Treas. Reg. §1.7874-7T.

- Prior acquisitions of U.S. targets by the foreign acquirer used to bolster a much larger single acquisition of a target<sup>14</sup>
- Prior acquisitions of foreign targets by the foreign acquirer used to bolster a much larger single acquisition of a target<sup>15</sup>
- The occurrence of certain transfers of stock of a foreign acquiring corporation, through a spin-off or otherwise, following an acquisition
- 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>16</sup>
- 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<sup>17</sup>
- 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>18</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>19</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 by imposing full withholding taxes on key payments such as dividends,<sup>20</sup> interest,<sup>21</sup> and royalties<sup>22</sup> made to connected persons that are residents of a treaty country by “expatriated entities” as defined under the Code. This lasts for ten years and goes to the heart of the bargain between the U.S. and its treaty partners, because the full withholding tax reduces the tax in the country of the recipient.

## 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

<sup>14</sup> Treas. Reg. §1.7874-8T.

<sup>15</sup> Treas. Reg. §1.7874-9T.

<sup>16</sup> Treas. Reg. §1.7874-10T.

<sup>17</sup> Treas. Reg. §1.7874-11T.

<sup>18</sup> Treas. Reg. §1.7874-12T.

<sup>19</sup> Treas. Reg. §1.304-7T.

<sup>20</sup> Paragraph 5 of Article 10 (Dividends) of the 2016 U.S. Model.

<sup>21</sup> *Id.*, ¶2(d) of Article 11 (Interest).

<sup>22</sup> *Id.*, ¶2 of Article 12 (Royalties).

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

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 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

- the Anti-Tax Abuse Directives (“A.T.A.D.”),
- 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, and
- limitations placed on the P.S.D. and the Interest and Royalties Directive 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 illegal 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 the European countries in which the companies making payment are resident. The challenges are directed at the substance of the holding company. Questions frequently asked include whether the holding company has payroll costs, occupancy costs, and local management involved in day-to-day decision-making. In some instances, the capital structure of the holding company is queried. For a U.S.-based group that has little tolerance to tax risk, these challenges suggest that it is prudent for a holding company to have more than 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 often 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.<sup>23</sup> 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 key areas include the following:

- 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
- 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.

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.

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

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<sup>23</sup> The full B.E.P.S. 2015 Final Reports appear online [here](#).

have been followed for the benefit of their investors, but governments may conclude that they are the victims of theft.

### 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 (“A.T.A.D. 1”). It was adopted on June 20, 2016, and contains anti-tax avoidance rules in five specific fields:

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

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

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

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

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

### **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>24</sup> in late December 2017. Among other things, the T.C.J.A. has

- reduced corporate tax rates to 21%,
- expanded the scope of C.F.C. rules,
- replaced the deemed paid foreign tax credit rules in connection with direct investment dividends received by corporations with an intercompany dividends received deduction (“D.R.D.”) applicable to dividends received from 10%-owned foreign subsidiaries,
- enacted deductions for the use of foreign-derived intangible income generated by U.S. businesses from operations in the U.S.,
- eliminated deferral for earnings of a C.F.C. derived from the use of intangible property,
- eliminated nonrecognition treatment for transfers of business assets to a foreign subsidiary,
- amended the transfer pricing statute (Code §482) to increase the income that is deemed to be realized from a transfer of ownership or use of intangible property to a foreign corporation,
- attacked the use of hybrid payments made by C.F.C.’s and foreign controlled U.S. companies, and
- imposed a Base Erosion and Anti-Abuse Tax (“B.E.A.T.”) on large U.S. companies making 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 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

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<sup>24</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.

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 shares *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.

Earlier this year, 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.

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>25</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>26</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>27</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>28</sup>

#### *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>29</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>30</sup>

The rate of U.S. tax on the amount included in income is reduced by means of a notional deduction.<sup>31</sup> For U.S. corporations, the rate is 15.5% to the extent that the

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<sup>25</sup> Code §245A.

<sup>26</sup> Code §245A(e)(2).

<sup>27</sup> Code §245A(e)(3).

<sup>28</sup> Code §904(d)(1)(B).

<sup>29</sup> Code §965.

<sup>30</sup> Code §965(e).

<sup>31</sup> Code §965(c).

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>32</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>33</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>34</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>35</sup>

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

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

The first step in computing G.I.L.T.I. is to eliminate the C.F.C.'s items of income that produce current tax.<sup>36</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

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<sup>32</sup> Code §965(g).

<sup>33</sup> Code §965(h).

<sup>34</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>35</sup> Code §951A.

<sup>36</sup> Code §951A(c)(2)(A)(i).

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>37</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>38</sup> The amount so determined is reduced by interest expense allocated against the tangible depreciable property.<sup>39</sup> The balance of the income is attributable to intangible property, which in turn gives rise to G.I.L.T.I. for U.S. Shareholders of a C.F.C.

### Netting of Tested Income

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

### Foreign Tax Credit Computations

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

- First, a deemed foreign tax credit is allowed for foreign income taxes attributable to G.I.L.T.I.<sup>40</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

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<sup>37</sup> Code §951A(b)(1).

<sup>38</sup> Code §951(b)(2)(A).

<sup>39</sup> Code §951(b)(2)(B).

<sup>40</sup> Code §960(d).



gross-up.<sup>41</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>42</sup> This reduction has no effect on the gross-up under Code §78.

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

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

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

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

Once the gross amount of G.I.L.T.I. is determined, a U.S. Shareholder that is a corporation is entitled to a 50% deduction based on the amount of G.I.L.T.I. included in income.<sup>43</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

<sup>41</sup> Code §78.

<sup>42</sup> Code §960(d)(1).

<sup>43</sup> Code §250.

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>44</sup> Although it is not certain, the income in the silo is expected to be entitled to the 50% deduction, as the legislative history of the T.C.J.A. describes the deduction as a “reduced rates” mechanism.<sup>45</sup> This characterization is important because an individual making the election to be taxed at corporate rates 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 That is 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>46</sup> The deduction relates to foreign-derived intangible income (“F.D.I.I.”) and shares many of the technical concepts of the G.I.L.T.I. regime, albeit in the context of exports.

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

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

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

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<sup>44</sup> Code §962.

<sup>45</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>46</sup> Code §250.

- 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>47</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>48</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>49</sup> paid to 25% foreign related persons.<sup>50</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>51</sup>

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

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

Modified taxable income under the B.E.A.T. Regime is broader than the concept of taxable income for regular tax purposes.<sup>52</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

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<sup>47</sup> Code §250(a)(1)(A).

<sup>48</sup> Code §59A.

<sup>49</sup> Code §59A(d).

<sup>50</sup> Code §59A(g).

<sup>51</sup> Code §59A(e)(1).

<sup>52</sup> Code §59A(c).

**“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.”**

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 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>53</sup> The I.R.S. is authorized to issue regulations that are necessary to prevent the avoidance of the B.E.A.T. Regime. Examples of abusive transactions include the use of unrelated persons, conduit transactions, or other intermediaries, or transactions or arrangements in ways that are designed, in whole or in part, to improperly recharacterize payments for the purpose of avoiding the B.E.A.T. Regime.

#### Limitations Placed on Business Interest Expense Deductions

Prior to the T.C.J.A., U.S. subsidiaries of foreign corporations were subject to an earnings stripping rule that applied when interest was paid to related parties outside the U.S. in circumstances where withholding tax was reduced or eliminated.<sup>54</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>55</sup> as well as certain electing real property, farming, and utilities businesses, from the application of the 30% ceiling.<sup>56</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.

<sup>53</sup> Code §59A(d)(5).

<sup>54</sup> Code §163(j).

<sup>55</sup> Code §163(j)(1)(C).

<sup>56</sup> Code §163(j)(1)(A).

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>57</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>58</sup>
- An exception to immediate gain recognition provided under prior law was eliminated,<sup>59</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.

## 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 illegal 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. Of course, in today's world, the tax benefits must be seen as non-abusive. Anticipated tax benefits arising under abusive plans may be ephemeral.

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<sup>57</sup> Code §§163(j)(3) and 448(c).

<sup>58</sup> Code §482.

<sup>59</sup> Code §367(a)(3) prior to enactment of the T.C.J.A.

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

**Author**  
Eric Fort  
*Arendt & Medernach*  
*Luxembourg*

## BACKGROUND

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

This project marks a sea change for some and the dawn of an improved system of international tax justice for others, especially academics and tax authorities. The B.E.P.S. Project originates from the meeting of government finance ministers and central bank governors from 20 major economies (the "G-20") in Moscow in 2013. The accompanying communiqué<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. Recent cases of tax evasion by large multinational enterprises ("M.N.E.'s") and the international financial crisis made states eager to prevent practices that enable B.E.P.S., and citizens have also become more sensitive to issues of tax fairness.

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

## 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.

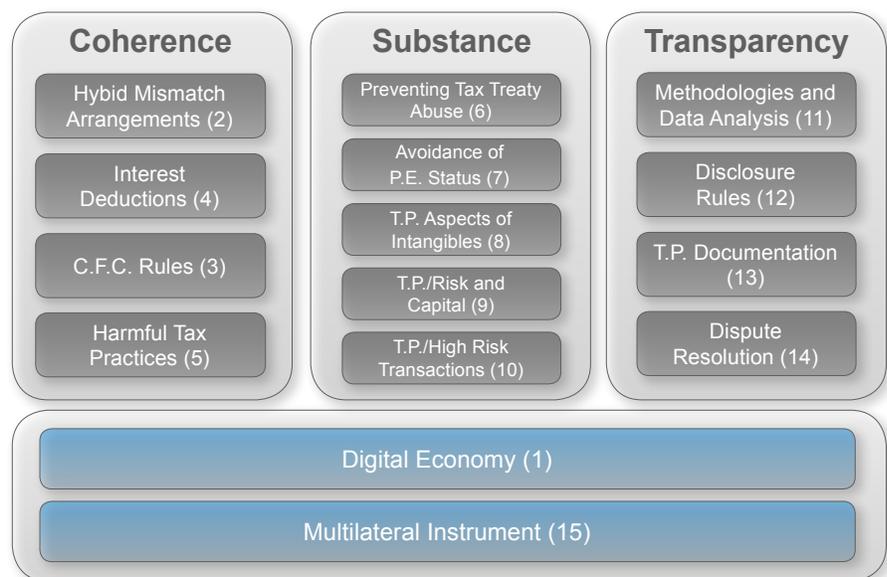
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proposed 15 measures to combat various forms of B.E.P.S. Adding to the February report, the Action Plan identifies elements of concern in relation to double nontaxation or low taxation and proposes concrete actions with deadlines for compliance.

The actions are organized around three main pillars:

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

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



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

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

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

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

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

*“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.”*

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

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

## REFLECTING A SEA CHANGE IN ACCEPTABLE TAX PLANNING

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

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

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

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

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

## EFFECTS ON HOLDING COMPANY STRUCTURES

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

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

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

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

### **Focus**

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

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

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

jurisdiction and as to their economic substance in another

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

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

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

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

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

Further, it should be noted that the O.E.C.D. issued additions to its Final Recommendations. The additions address hybrid mismatches<sup>6</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 section and due to the broad scope of Action Item 2, only a few examples of hybrid mismatch arrangements will be presented. Typical hybrid mismatches that lead to a D./N.I. outcome are illustrated by structures involving hybrid financial instruments. The instrument is treated as debt in the issuer’s country of residence and as equity in the holder’s country. The issuer of the instrument treats its payment as deductible interest and the payee/holder treats the payment as a tax-exempt dividend.

Another example of hybrid mismatch can be found in arrangements with payments to reverse hybrid entities. Such entities are treated as tax transparent in one jurisdiction and as opaque in another. By way of illustration, a company that is resident in Country A owns all the issued and outstanding shares in a subsidiary resident in Country B. The subsidiary was formed under the laws of Country B. The subsidiary is tax transparent under Country B’s laws but is regarded as a separate taxable entity under the laws of Country A. Company C, residing in Country C, borrows money from the subsidiary and makes an interest payment under the loan. The payment is deductible under Country C’s tax law but is not included in income under the laws of either Country A or B. Each of those countries treats the income as being derived by a resident of the other jurisdiction.<sup>7</sup>

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<sup>6</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 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

<sup>7</sup> O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements*,

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.

As to treaty language, the report sets out a range of recommendations for changes to the O.E.C.D. Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly. The latest edition of the O.E.C.D. Model Tax Convention released on December 18, 2017 notably reflects the additional hybrid mismatches recommendations under Action Item 2.

## **B.E.P.S. ACTION 3: DRAFTING EFFECTIVE CONTROLLED FOREIGN COMPANY RULES<sup>8</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

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*Action 2 – 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

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

other jurisdictions in order to be repositories of diverted income. In other words, the aim of the C.F.C. rules is to avoid the shift of income by ensuring that profits remain in the taxable base of the controlling entity in relation to the C.F.C.

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

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

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

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

### **Recommended Actions**

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

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

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



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

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

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

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

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

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

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

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

### **Focus**

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

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

- intra-group loans to generate deductible expenses in a high-tax jurisdiction

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<sup>9</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 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

and taxable interest income in low-tax jurisdictions,

- interest deductions on loans that finance assets that produce exempt income or income recognized on a deferred basis,
- hybrid mismatches between jurisdictions generating interest deductions but no taxation of income, and
- a disproportionate level of third-party debt incurred by companies located in high-tax jurisdictions compared to the group overall debt.

### **Recommended Action**

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/group E.B.I.T.D.A.). This combination may be included in a separate rule or as part of the general overall provision.

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

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

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

### **Focus**

Another B.E.P.S. Action substantially affecting holding companies is the portion of Action Item 5 that is intended to “counter harmful tax practices more effectively, taking into account transparency and substance.” Previous O.E.C.D. publications, such as the O.E.C.D.’s 1998 report *Harmful Tax Competition: An Emerging Global Issue*,<sup>10</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**

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

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

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

### **Recommended Action**

In October 2015, a final report on Action Item 5 was published.<sup>11</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

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

<sup>11</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 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

this section.

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

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

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

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

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



<sup>12</sup> *Id.*, p. 46.

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/checking procedure to be put in place, and a final statement on the publication and exchange of information.

On February 1, 2017, the O.E.C.D. released the *Terms of Reference and Methodology for Peer Reviews*<sup>13</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 will be subject to a peer review of their implementation.

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

### **Focus**

As mentioned in the introduction to this article, holding companies may be used as a tool for tax planning and treaty shopping. Treaty shopping normally involves a

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<sup>13</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./G-20 Base Erosion and Profit Shifting Project, O.E.C.D., Paris.

resident of a country gaining access to a tax treaty between two other states either through a conduit company or by any other arrangements in circumstances where the resident would not otherwise have been able to claim a comparable benefit to reduce its overall taxable burden.

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

The B.E.P.S. Action Plan has identified treaty abuse, and particularly treaty shopping, as one of the most important sources of base erosion and profit shifting. The Final Recommendations on Action Item 6<sup>14</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:

- Inclusion in the title and preamble of tax treaties of a clear statement that the contracting states, when entering into a treaty, intend to avoid creating opportunities for nontaxation or reduced taxation
- Inclusion in tax treaties of a specific anti-abuse rule based on the limitation on benefits (“L.O.B.”) provisions, as are already provided in treaties concluded by the United States and a few other countries
- 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>15</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>16</sup> would not qualify under the L.O.B. rules, as they do not meet any of the proposed requirements.<sup>17</sup> Regarding their particular activity, discussions are taking place to determine whether these non-C.I.V. funds should qualify *per se*

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<sup>14</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 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

<sup>15</sup> *Id.*

<sup>16</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>17</sup> O.E.C.D. (2015), *Revised Discussion Draft, B.E.P.S. Action 6: Prevent Treaty Abuse*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D. Publishing, Paris.

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>18</sup>

Since the L.O.B. clause might not catch all “conduit arrangements,” a G.A.A.R provision should be included in future tax treaties to deny benefits “if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit.”<sup>19</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 raises issues with regard to E.U. law since it targets arrangements where “one of the principal purposes” is the intention to obtain the treaty benefits. The proposed P.P.T. rule may therefore be considered too extensive with respect to E.U. fundamental freedoms. The European Court of Justice has stated:

[A] national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.<sup>20</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>21</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

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

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

<sup>20</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>21</sup> O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, p. 19, ¶21-22.

clearly lead to double taxation and thus, would require further work in the first part of 2016. Additionally, Action Item 6 addresses the issue of exit or departure taxes by confirming that clarification will be made to the commentary on the O.E.C.D. Model Tax Convention to maintain domestic application.

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

The latest edition of the O.E.C.D. Model Tax Convention released on December 18, 2017 notably reflects the treaty-related recommendations under Action Item 6 of the B.E.P.S. Action Plan.

## **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 Depository for the M.L.I., with a list of the treaties to be covered (“Covered Treaties”), as well as the options that were implemented by the relevant state in the Covered Treaties.

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

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

#### ***Hybrid Mismatches***

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

#### **Transparent Entities**

Article 3.1 of the M.L.I. introduces a new rule for the application of a tax treaty to

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

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

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

### Dividend Transfer Restriction

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

### Capital Gains Derived Indirectly from Real Estate

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

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

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

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

### Saving Clause

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

### Avoidance of Permanent Establishment Status

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

### Commissionaire Arrangements

A *commissionaire* arrangement is one in which an independent agent, or *commissionaire*, sells products in a state under its own name but on behalf of a foreign enterprise. Under the current definition of "permanent establishment" in the O.E.C.D. Model Tax Convention, an enterprise is able to use a *commissionaire* arrangement



to avoid having a permanent establishment in the state where the sale actually occurs, while the *commissionaire*, not being the owner of the assets, only receives remuneration for his services.

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

This amendment is optional for the Contracting States.

#### Specific Activity Exemptions

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

This amendment is optional for the Contracting States.

#### Splitting-Up of Contracts

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

#### Dispute Resolution and Arbitration

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

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

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

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

### Reservations

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

### Timing

The M.L.I. has been open for signature as of December 31, 2016. A formal signing ceremony was held in Paris on June 7, 2017. As of January 24, 2018, the M.L.I. has been signed by a total of 78 jurisdictions. Following signature, Contracting States must complete the domestic procedures necessary to ratify the M.L.I.

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

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

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

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

### Conclusion

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

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

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

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

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

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

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

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

On May 29, 2017, the E.U. Council adopted a directive to amend the A.T.A.D. (“A.T.A.D. 2”) in order to extend the scope of the provisions on hybrid mismatches from E.U. Member States to include third countries and align A.T.A.D. with the recommendations of Action Item 2. 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. Council 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.

# EUROPEAN TAX LAW

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

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

## 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 affects or may affect competition and trade between the Member States.<sup>3</sup>
- The advantage is selective, *i.e.*, it is only granted to specific recipients.<sup>4</sup>

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

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

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

<sup>2</sup> State Aid and Direct Business Taxation, *supra* note 1, ¶9.

<sup>3</sup> *Id.*, ¶11.

<sup>4</sup> *Jestaed* in Heidenhain, European State Aid Law, 2010, §8 ¶9.

<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.”].

**“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.”**

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 should 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 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>

<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).

<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 [hereinafter the “Procedural Regulation”].

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

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

<sup>15</sup> T.F.E.U., *supra* note 5, art. 108, §2.

<sup>16</sup> Procedural Regulation, *supra* note 12, art. 16, §1.

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

The principle of incompatibility of State Aid with the internal market applies to aid “in any form whatsoever.”<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>

### **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 that is equivalent to fiscal expenditures funded by state resources.<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>

### **Negative Impact on Trade and Competition**

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

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<sup>17</sup> State Aid and Direct Business Taxation, *supra* note 1, ¶2.

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

<sup>19</sup> *Id.*, ¶9.

<sup>20</sup> State Aid in the T.F.E.U., *supra* note 1, ¶156, et seq.

<sup>21</sup> State Aid and Direct Business Taxation, *supra* note 1, ¶10.

<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, *supra* note 1, ¶10.

<sup>24</sup> *Id.*, ¶11.

### Selectivity

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

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

In comparison, a decisive factor is whether an identified tax measure is an exception to the application of a Member State's general tax system. Therefore, the determination of selectivity requires a multistage test. As a first step, the tax system in issue and the deviation from the standard provision must be identified. Then, a determination must be made whether the deviation is justified "by the nature or the general scheme" of the tax system.<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, for example, that progressive tax rates are justified by the redistributive purposes of income taxes, and that the exemption of non-profit organizations, *i.e.*, foundations or associations, is justified by the fact that only income is subject to tax within the income tax system.<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>

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<sup>25</sup> *Id.*, ¶13.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*, ¶14.

<sup>28</sup> *Id.*, ¶16.

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

<sup>30</sup> State Aid and Direct Business Taxation, *supra* note 1, ¶16.

<sup>31</sup> *Id.*, ¶24-25.

<sup>32</sup> *Id.*, ¶23.

## **Recovery of Unlawful State Aid**

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

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>33</sup> or if the protection of the doctrine of legitimate expectation overrides the need for recovery.<sup>34</sup> These exemptions are rarely applicable. Further, the recovery of unlawful State Aid is subject to a limitation period of ten years.<sup>35</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>36</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>37</sup> Therefore, national rules providing that an administrative decision cannot be appealed after the expiration of a limitation period<sup>38</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>39</sup>

## **Illustrative Examples**

In the past few years, tax provisions have been subject to increasingly rigorous scrutiny as to whether they constitute State Aid. Investigations in the context of international business taxation suggest that the Commission views aggressive tax planning and tax base erosion by large multinationals as examples of State Aid.<sup>40</sup> Targets of these investigations include aid to (i) Apple granted by Ireland,<sup>41</sup>



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

<sup>34</sup> *Id.*, §32, ¶24.

<sup>35</sup> Procedural Regulation, *supra* note 12, art. 17, §1.

<sup>36</sup> *Id.*, art. 16, §2.

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

<sup>38</sup> *Id.*, ¶38.

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

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

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

(ii) Starbucks granted by the Netherlands,<sup>42</sup> and (iii) Fiat granted by Luxembourg.<sup>43</sup>

In those cases, the 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 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>44</sup>

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

Another example is the in-depth investigations opened by the Commission in February 2015 regarding the Belgian excess profit ruling scheme.<sup>47</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>48</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>49</sup> The Commission Decision required Belgium to stop applying the excess profit scheme and to recover the full unpaid tax from the at least 35 multinational

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

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

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

<sup>45</sup> *State Aid to Apple*, C(2016) 5605 Final.

<sup>46</sup> *Id.*

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

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

**“National provisions regarding direct business taxation may be considered State Aid if the definitional criteria of the T.F.E.U. are met.”**

companies that benefited from the illegal scheme (around €700 million).<sup>50</sup>

In February 2016, the General Court (“E.G.C.”) confirmed the Commission Decision<sup>51</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>52</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 therefore escape qualification as State Aid. This argument convinced neither the Commission nor the E.G.C.<sup>53</sup> However, in his conclusions<sup>54</sup> on the pending appeal before the E.C.J., Advocate General Nils Wahl followed the German authorities’ view, arguing that the utilization of a carryforward constitutes a general principle in the corporate tax law of Germany. Therefore, the “restructuring relief” clause restores this general principle and accordingly should not be qualified as selective.

The increasing relevance of State Aid law to E.U. Member States’ tax legislation is also evidenced by two more provisions of German tax law that have recently come under scrutiny. Namely, these rules are the newly-introduced income tax exemption of debt waiver gains for the restructuring of distressed businesses<sup>55</sup> and the exemption of intra-group transactions from real estate transfer tax.<sup>56</sup> These rules are currently subject to review by the European Commission and the E.C.J., respectively.

One of the latest rulings of the E.C.J. relates to a Spanish provision under which goodwill could be deducted when a Spanish-resident corporation acquired a shareholding in a foreign company equal to at least 5%.<sup>57</sup> No tax deduction for goodwill was granted when acquiring a shareholding in a domestic company. Even though the E.C.J. remitted the decision to the E.G.C., the ruling gave clear instruction on how the E.C.J. defines selectivity: A measure that places one undertaking in a position that is more favorable than that of another undertaking, although both undertakings are in a comparable factual and legal situation, may be viewed as selective.<sup>58</sup>

<sup>50</sup> *Id.*

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

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

<sup>53</sup> Appeal proceedings before the E.C.J. (Case C-219/16 P, C-203/16 P) are pending.

<sup>54</sup> Opinion of the Advocate General, December 20, 2017 (Case C-203/16 P).

<sup>55</sup> Sec. 3a *Einkommensteuergesetz – EstG* [Income Tax Act] and Sec. 3a *Gewerbesteuerengesetz – GewStG* [Trade Tax Act].

<sup>56</sup> Sec. 6a *Grunderwerbsteuergesetz – GrEStG* [Real Estate Transfer Tax].

<sup>57</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>58</sup> *Id.*, ¶179.

There is no need to identify certain specific features that characterize a group of undertakings that are beneficiaries to the tax advantage.<sup>59</sup>

## TRANSPARENCY MEASURES

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

### **Current Measures**

Currently, Council Directive 2011/16/E.U. (the “Administrative Cooperation Directive”), as amended,<sup>60</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. Pursuant to this Directive, Member States are obligated to share information that is foreseeably relevant to the administration of all taxes (except for V.A.T. and customs duties, excise duties, and compulsory social contributions) of another Member State in three different situations.<sup>61</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>62</sup>

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<sup>59</sup> *Id.*, ¶78.

<sup>60</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>61</sup> Administrative Cooperation Directive, *supra* note 60, art. 2, §2.

<sup>62</sup> *Id.*, art. 8, §3(a), as amended by Council Directive 2014/107/E.U., *supra* note 60.



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

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

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

#### *Spontaneous Exchange of Information*

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

- The Member State supposes that there may be losses of tax in another Member State.
- A tax exemption or reduction in one Member State might give rise to an 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>63</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>64</sup>

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<sup>63</sup> *Id.*, art. 9, §1.

<sup>64</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>65</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 Report. The competent national authority that receives the CbC Report must communicate the report by automatic exchange to any other Member State in which one or more constituent entities of the multinational group are either resident for tax purposes or are subject to tax with respect to business carried out through a permanent establishment. The CbC Report is filed in the Member State in which the ultimate parent entity of the group or any other reporting entity is a resident for tax purposes. The report must include the following information for every tax jurisdiction in which the group is active:

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

In general, CbC Reports must be provided within 15 months of the last day of the fiscal year of the reporting multinational group. The rule is somewhat different for the first CbC Reports. The first reports must relate to the reporting group's fiscal year commencing on or after January 1, 2016, and must be submitted within 18 months of the last day of that fiscal year.<sup>66</sup>

Germany implemented the provisions relating to CbC Reporting and the automatic exchange of cross-border tax rulings and advance pricing arrangements into law on December 20, 2016.<sup>67</sup>

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<sup>65</sup> *Supra* note 60. 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>66</sup> *Id.*, art. 1, ¶2.

<sup>67</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”].

## **Tax Transparency Package**

As part of its efforts to tackle corporation income tax avoidance and harmful tax competition in the E.U.,<sup>68</sup> and certainly as a reaction to the State Aid investigations resulting from the tax rulings to multinationals,<sup>69</sup> the Commission presented a package of tax transparency measures in March 2015. Two of the proposals included in this package, *i.e.*, (i) the automatic exchange of information regarding cross-border tax rulings and advance pricing arrangements, (ii) and the CbC Reporting obligation, have already been implemented.<sup>70</sup>

## **Action Plan**

On June 17, 2015, the Commission presented an Action Plan for Fair and Efficient Corporate Taxation in the E.U. that is partially tied into the tax transparency package.<sup>71</sup> Key actions include a plan to relaunch the Common Consolidated Corporate Tax Base (“C.C.C.T.B.”)<sup>72</sup> and to establish of a framework to ensure effective taxation in the country where profits are generated (*e.g.*, modifications to the Code of Conduct for Business Taxation, and measures to close legislative loopholes, improve the transfer pricing system, and implement stricter rules for preferential tax regimes).<sup>73</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 non-cooperative tax jurisdictions and an assessment of further options).<sup>74</sup> The Commission also promoted greater cooperation between Member States in the area of tax audits.<sup>75</sup>

## **Public Tax Transparency Rules for Multinationals**

On April 12, 2016, the Commission proposed the introduction of a requirement for multinational companies operating in the E.U. (both E.U. residents and non-E.U. residents) with global revenues exceeding €750 million a year to publish key information on where the profits are generated and where taxes are paid in the E.U. on a country-by-country basis. Aggregate figures would also have to be provided for operations in non-E.U. tax jurisdictions. In addition, contextual information (such as turnover, number of employees, and nature of activities) would have to be disclosed for every E.U. country in which a company is active, as well as for those tax jurisdictions that do not abide by tax good governance standards (*i.e.*, tax havens). The information will remain available for five years.<sup>76</sup> The proposal is undergoing the

<sup>68</sup> Commission Press Release, IP/15/4610 (Mar. 18, 2015).

<sup>69</sup> See **Illustrative Examples** above.

<sup>70</sup> See **Common Reporting Standards** below.

<sup>71</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) [hereinafter “5 Key Areas”].

<sup>72</sup> Commission Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 Final (Oct. 2016).

<sup>73</sup> 5 Key Areas, *supra* note 71, p. 7.

<sup>74</sup> *Id.*, p. 12.

<sup>75</sup> *Id.*, p. 14.

<sup>76</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.

parliamentary process, facing some criticism.<sup>77</sup>

### **Common Reporting Standards**

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

With respect to listed companies, Council Regulation 1606/2002/E.C., as amended,<sup>78</sup> grants the Commission the authority to adopt the International Financial Reporting Standards, the International Accounting Standards, and the related Interpretations (“S.I.C./I.F.R.I.C.-Interpretations”) issued by the International Accounting Standards Board (“I.A.S.B.”).<sup>79</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>80</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>81</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>82</sup> and the Prospectus Directive.<sup>83</sup>

- Pursuant to the Transparency Directive, issuers are required to inform the public market periodically about their financial statements and their management report.<sup>84</sup>
- Pursuant to the Transparency Directive, shareholders of listed companies are subject to reporting obligations if their voting rights exceed or fall below

***“The Commission proposed the introduction of a requirement for multinational companies operating in the E.U. 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.”***

<sup>77</sup> See the suggested amendments to the Commission’s proposal in the Council’s statement of December 19, 2016, Interinstitutional File 2016/0107 (COD), document no. 15243/16.

<sup>78</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 Commission, 2008 O.J. L 97/62.

<sup>79</sup> Application of I.A.S., *supra* note 78, art. 2 and art. 3, §1.

<sup>80</sup> Commission Regulation 1126/2008/E.C. Adopting Certain International Accounting Standards, 2008 O.J. L 320/1.

<sup>81</sup> For further details regarding the endorsement process, see Application of I.A.S., *supra* note 78, art. 6, and Council Decision No. 1999/468/E.C., 1999 O.J. L 184/23, art. 5(a) and art. 8.

<sup>82</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>83</sup> Council Directive 2003/71/E.C. on the Prospectus to be Published When Securities are Offered to the Public or Admitted to Trading, 2003 O.J. L 345/64 [hereinafter the “Prospectus Directive”].

<sup>84</sup> Transparency Directive, *supra* note 82, Chapter II.

defined thresholds following an acquisition or a disposal of shares.<sup>85</sup>

- Pursuant to the Prospectus Directive, issuers of securities offered to the public are obliged to publish a comprehensive prospectus reporting information concerning the issuer and the securities to be offered.<sup>86</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>87</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>88</sup>

In addition, a recently-issued directive requires large groups to report non-financial and diversity information. The affected companies will be obligated to publish information providing an understanding of the undertaking's development, performance, and position, the impact of its activity on environmental, social, and employee matters, and its respect for human rights and handling of anti-corruption and anti-bribery matters. The Member States were required to transfer these provisions into domestic law by December 6, 2016.<sup>89</sup>

## ANTI-TAX AVOIDANCE PACKAGE

In January 2016, the Commission adopted an Anti-Tax Avoidance Package as part of its agenda for fair corporate taxation in Europe. The package contains concrete measures to “prevent aggressive tax planning, boost tax transparency and create a level playing field for all businesses in the E.U.”<sup>90</sup> One key element of this package is the Anti-Tax Avoidance Directive (“A.T.A.D. 1”). It introduced five legally-binding

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<sup>85</sup> *Id.*, Chapter III.

<sup>86</sup> Prospectus Directive, *supra* note 83, art. 5.

<sup>87</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>88</sup> *Id.*, art. 53, §1.

<sup>89</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.

<sup>90</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).

anti-abuse measures that all Member States must apply against common forms of aggressive tax planning by December 31, 2018.<sup>91</sup> Its scope was expanded by A.T.A.D. 2 with regard to hybrid mismatches with third countries.

A.T.A.D. applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments in one or more Member States of entities resident for tax purposes in a third country.<sup>92</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>93</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 carried back for three years. Excess interest capacity in any year can be carried forward for five years. Member States can postpone the implementation of the interest expense limitation rule, provided a national rule is in place preventing base erosion and profit shifting that provides a comparable result. The deferred implementation date cannot be later than January 1, 2024, and may be advanced in the event of an earlier implementation date in the comparable O.E.C.D. provision under the B.E.P.S. Action Plan.

### **Exit Taxation**

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

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

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<sup>91</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 [hereinafter "A.T.A.D. 1"], 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. 2"].

<sup>92</sup> *Id.*, art. 1, §2.

<sup>93</sup> This provision on the interest limitation rule is similar to the current German interest limitation rule.

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

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

A taxpayer may pay these exit taxes in installments over at least five years for transfers within the E.U. or the E.E.A.<sup>94</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>95</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 proposed controlled foreign company (“C.F.C.”) rules re-attribute the income of a low-taxed C.F.C. to its parent company. This will be achieved by adding the undistributed income of an entity to the tax base of a taxpayer in the following cases:

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

<sup>94</sup> A.T.A.D. *supra* note 91, art. 5.

<sup>95</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.

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

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

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



### **Hybrid Mismatches**

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

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

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

A.T.A.D. 1 was limited to hybrid mismatches that arise from interactions between two Member States. Provisions concerning hybrid mismatches involving third countries were not included. In order to remedy this insufficient territorial scope, the E.U. Council adopted A.T.A.D. 2,<sup>96</sup> which was aimed at neutralizing the tax effects of hybrid mismatches involving countries other than E.U. Member States, consistent with the recommendations outlined in the O.E.C.D. B.E.P.S. Report on Action Item 2.<sup>97</sup>

In addition to broadening the territorial scope, the amended provisions<sup>98</sup> address further types of hybrid mismatches that were not covered by A.T.A.D. 1. These additional rules on hybrid mismatches are divided into three provisions.

### Expansion of the Definition of Hybrid Mismatches<sup>99</sup>

While hybrid mismatches were addressed by Article 9 of A.T.A.D. 1, the amended version now acts as a catch-all element tying into the broadly-defined terms “hybrid mismatch” and “hybrid transfer.” In comparison to the original scope, the A.T.A.D. 2 provision additionally covers the following structures:

- “Hybrid permanent establishment mismatches” occur when two jurisdictions differ on whether or not a business activity is being carried out through a permanent establishment.
- “Hybrid transfers” occur when two jurisdictions differ on whether the transferor or the transferee of a financial instrument has ownership of the payments on the underlying asset.
- “Imported mismatches” occur when 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>100</sup>

Reverse hybrid mismatch structures occur when an entity is considered transparent by the Member State in which it is incorporated or established, but a direct or indirect interest in 50% or more of the voting rights, capital interest, or rights to a share of its profit is held in aggregate by one or more associated nonresident entities located in a third country that does not consider the entity transparent. Pursuant to Article 9a(1), the hybrid entity will be regarded as a resident of the Member State and taxed on its income that is not otherwise taxed under the laws of the Member State or any other jurisdiction.

This provision will 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

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<sup>96</sup> Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

<sup>97</sup> O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*.

<sup>98</sup> *Id.*, art. 9, 9a, 9b.

<sup>99</sup> *Id.*, art. 9.

<sup>100</sup> *Id.*, art. 9a. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.

subject to investor protection regulations in the country in which it is established.<sup>101</sup>

### Tax Residency Mismatches<sup>102</sup>

Tax residency mismatches can occur when a taxpayer is resident for tax purposes in two or more jurisdictions. A deduction for payments, expenses, or losses from the tax base of such a taxpayer may be possible in multiple jurisdictions.

Article 9b directs any Member State in which a taxpayer is resident to deny deductions that another jurisdiction allows 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 relevant tax treaty will deny the deduction.

Member States are required to adopt A.T.A.D. 2 into domestic tax law by January 1, 2020, and the reverse hybrid mismatch rules must be adopted by January 1, 2022.

## CONCLUSION

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

**“By shining a light on tax planning and rulings, the Commission hopes to obtain a level playing field for all Member States regarding tax policy.”**

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<sup>101</sup> *Id.*, art. 9a, §2.

<sup>102</sup> *Id.*, art. 9b.

## LUXEMBOURG

### Author

Mélanie Staes

Loyens & Loeff

New York, United States

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 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 such, 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 Luxembourg dividend tax. Considering that a S.O.P.A.R.F.I. is fully subject to Luxembourg income tax, it is generally entitled to the benefits of the tax treaties concluded between Luxembourg and other countries and the E.U. tax directives.

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

Besides the S.O.P.A.R.F.I. and the various investment fund platforms, Luxembourg law provides for 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 in **S.I.C.A.R.**, **R.A.I.F.**, and **Securitization Vehicles**, respectively, below.

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## 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 26.01% as of January 1, 2018. This rate includes the national corporation income tax (“C.I.T.”), plus the Luxembourg City municipal business tax, and a 7% unemployment fund surcharge. Effective January 1, 2016, the fixed minimum C.I.T. for a S.O.P.A.R.F.I. was abolished and replaced by a minimum net wealth tax, which is largely similar to the former minimum corporate tax. As of January 1, 2017, the minimum net wealth tax for a S.O.P.A.R.F.I. was increased from €3,210 to €4,815. See **Annual Net Worth Tax** below for further details.

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

### **Dividends**

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

- a. The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax-transparent entity), or the participation has an acquisition cost of at least €1.2 million.
- b. The subsidiary is (i) an entity falling within the scope of Article 2 of the E.U. Parent-Subsidiary Directive (2011/96/E.U.), as amended from time to time, (the “P.S.D.”) or a permanent establishment thereof, provided the hybrid loan provision and the general anti-abuse rule known as “G.A.A.R.” do not apply, (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.
- 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, by law of December 18, 2015, and effective as of January 1, 2016, the Luxembourg participation exemption was amended in line with the revised P.S.D.<sup>1</sup> and includes a provision countering hybrid loan arrangements and implementing G.A.A.R. The hybrid loan provision aims at preventing double nontaxation via the use of hybrid financing arrangements by limiting the exemption of payments received through such arrangements if such payment is deducted in another E.U. Member State. The anti-abuse provision requires E.U. Member States to refrain from granting the benefits of the P.S.D. to certain arrangements that are not “genuine.” For the arrangement to be non-genuine,

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<sup>1</sup> The P.S.D. was amended in 2014 and 2015 by Council Directive 2014/86/E.U. and Council Directive 2015/121, respectively.

*“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.”*

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 G.A.A.R. in order for the exemption to apply. 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 may be available notwithstanding 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 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 S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, a minimum participation, as mentioned above, for an uninterrupted period of at least 12 months.

The capital gains exemption is not subject to G.A.A.R. as implemented in Luxembourg 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 be subject to a comparable tax in their country of residence.

Based on parliamentary documents, this requirement is to be understood as follows: A foreign corporation income tax is comparable if it is levied at a rate of at least 9%

(as of 2018) and the tax is computed on a basis that is similar to the basis used in Luxembourg. No list of qualifying countries exists for this purpose. Where comparability is subject to doubt, an advance tax agreement (“A.T.A.”) can be requested from the Luxembourg tax authorities.

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

## DIVIDENDS OR CAPITAL GAINS AFTER SHARE EXCHANGE

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

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

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

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

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

## 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 (refer to **Subject to Tax** above).

## PARTIAL PARTICIPATION EXEMPTION

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

As of the date of this article, Luxembourg has 80 income tax treaties in force with the following jurisdictions:

Andorra	Armenia	Austria	Azerbaijan
Bahrain	Barbados	Belgium	Brazil
Brunei	Bulgaria	Canada	China
Croatia	Czech Republic	Denmark	Estonia
Finland	France	Georgia	Germany
Greece	Guernsey	Hong Kong	Hungary
Iceland	India	Indonesia	Ireland
Isle of Man	Israel	Italy	Japan
Jersey	Kazakhstan	Laos	Latvia
Liechtenstein	Lithuania	Macedonia	Malaysia
Malta	Mauritius	Mexico	Moldova
Monaco	Morocco	Netherlands	Norway
Panama	Poland	Portugal	Qatar
Romania	Russia	San Marino	Saudi Arabia
Serbia	Seychelles	Singapore	Slovakia
Slovenia	South Africa	South Korea	Spain
Sri Lanka	Sweden	Switzerland	Taiwan
Tajikistan	Thailand	Trinidad & Tobago	Tunisia
Turkey	Ukraine	United Arab Emirates	United Kingdom
United States	Uruguay	Uzbekistan	Vietnam

Additionally, Luxembourg is in the process of concluding and ratifying 16 income tax



treaties, six of which are still being negotiated. Of those 16, one is a protocol being negotiated and 15 are either new treaties or existing treaties being renegotiated. In 2017, Luxembourg and Cyprus signed a treaty which was ratified by Luxembourg in 2018 and is expected to enter into force in 2019. Cyprus was the only E.U. Member State with which Luxembourg did not have a tax treaty.

Luxembourg signed the Multilateral Instrument on June 7, 2017 and at that time did not exclude any of its 80 tax treaties currently in force, nor the new treaty with Senegal (ratified by Luxembourg). Luxembourg has however made a number of reservations regarding specific provisions. Luxembourg has chosen option A in relation to Article Item 5 (Application of Methods for the Elimination of Double Taxation) and the principal purpose test 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), and Article Item 15 (Definition of a Closely Related Persons).

As of the June 15, 2018, a draft legislative proposal to ratify the Multilateral Instrument has not been published and no time for publication has been formally or informally announced.

## DEDUCTION OF COSTS

### Value Adjustments

A S.O.P.A.R.F.I. may make deductible value adjustments on a participation. The deductions can be used to offset other income (such as income from financing activities or commercial activities) and may result in tax losses. Losses that were incurred before 2017 may be carried forward indefinitely. However, losses that were incurred as of January 1, 2017 can be carried forward for 17 years after the losses occurred. Carry-back 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 **Capital Gains** 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 tax deductible to the extent that they exceed exempt income arising from the participation in a given year. The deducted amount can be used to offset other types of income and capital gains resulting from a subsequent disposition of shares, subject to the recapture rule described above.

In principle, expenses are allocated on 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 also below with respect to liquidation dividends.) Under Article 147 of the I.T.A., exemptions may apply for dividend distributions from a Luxembourg company, if certain conditions are met, to one of the following entities:

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

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

- The dividend is paid to 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>2</sup>

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

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 in **General/Participation Exemption** above before an exemption from withholding tax on dividends is applied to an E.U.-resident corporation, the arrangement by which the S.O.P.A.R.F.I. is held must be tested under the European G.A.A.R. of the P.S.D. as implemented in Luxembourg law. An improper, non-commercial purpose for the holding may prevent the application of the exemption. For non-E.U. shareholders, no such test is applicable. In addition, the Luxembourg domestic withholding tax exemption may be available notwithstanding G.A.A.R., if the shareholder meets the comparable tax test as referred to in item (d) above and further detailed in **Subject to Tax** above, which should be the case in the context of an income tax treaty, which should be the case for many shareholders that are entities resident in an E.U. Member State.

### **Interest Payment on (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.

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

Under certain conditions, hybrid debt instruments may be issued by a S.O.P.A.R.F.I. These hybrid debt instruments (*e.g.*, convertible preferred equity certificates commonly referred to as "C.P.E.C.'s") are normally treated as debt for Luxembourg legal, accounting, and tax purposes, but may be treated as equity for tax purposes in the country of residence of the holder of the instrument such as the U.S.<sup>3</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 in **General/Participation Exemption** above, the use of hybrid instruments may be limited where two E.U. Member States are concerned. In Luxembourg, however, no legislation has been implemented that would bar the deduction of interest paid on hybrid instruments issued by a Luxembourg company.

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

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<sup>3</sup> While outside of the scope of this article, 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 the C.P.E.C. to be treated as fully taxable dividends that do not bring along indirect foreign tax credits.

mismatch arrangements through deduction limitations and a general anti-abuse rule.

In this context, two Council Directives establishing rules to combat tax avoidance practices that directly affect the functioning of the internal market (the Anti-Tax Avoidance Directive (2016/1164), or “A.T.A.D.,” and the Anti-Tax Avoidance Directive 2 (2017/952), or “A.T.A.D. 2,” together referred to as the “A.T.A.D.’s”) have been adopted. 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
- Controlled foreign corporation (“C.F.C.”) legislation
- Hybrid mismatch rules and reverse hybrid mismatch rules

The implementation date is January 1, 2019, except for the exit taxation provision (January 1, 2020), the hybrid mismatch rules (January 1, 2020), the reverse hybrid mismatch rules (January 1, 2022) and the interest deduction limitation provision (in principle January 1, 2020, but extended to January 1, 2024, subject to certain conditions). Certain components of the implementation of the A.T.A.D.’s will require changes to currently existing corporate income tax rules, such as interest deduction limitations, but others will also require the introduction of completely new sets of regulations in many E.U. Member States, including Luxembourg, such as those governing C.F.C.’s and hybrid mismatches. It is therefore anticipated that the A.T.A.D.’s will have a substantial impact on structures relying on hybrid entities and instruments that are currently common practice (such as C.P.E.C.’s that do not lead to current taxation for the holder in its country of residence) and on the use of permanent establishments.

## CAPITAL GAINS IN HANDS OF SHAREHOLDERS

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

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

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

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

*“Capital gains arising from a disposition of shares may be taxable in part and offset by available losses carried forward.”*

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 relatively recent case,<sup>4</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.

On the basis of current 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 illegal 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.

## OTHER TAX ISSUES

### Debt-to-Equity Ratio

Luxembourg law does not contain any provisions regarding debt-to-equity ratios. However, a debt-to-equity ratio of 85:15 is generally required in practice 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

<sup>4</sup> Administrative Court, March 3, 2017, no. 39193C.

matters which is discussed in **Transfer Pricing Regulations** below. 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. How much equity should be placed in a group finance subsidiary is a factual question and no set formula has been adopted. Consequently, each situation is to be determined on a case-by-case basis.

### **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, as described in **General/Participation Exemption** above is applicable. Note, however, that there is no minimum holding period requirement with regard to the net worth tax exemption.

A fixed minimum net wealth tax applies, set at €4,815 (as of January 1, 2017) (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.

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

The procedure to obtain an advance tax agreement ("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.

*"The repurchase could be viewed in certain circumstances as a 'simulated' dividend that is subject to dividend tax (if no exemption applies)."*

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, EU or international law.

Subject to the foregoing requirements, case law<sup>5</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.
- 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.

In an advance pricing agreement (“A.P.A.”), the arm’s length character of the remuneration to be earned by a Luxembourg company on its intra-group transactions is confirmed by the tax authorities. 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 in this respect **Transfer Pricing Regulations** below.

Over the last few years, the European Commission has continued its examination of the A.T.A. and A.P.A. practices of various E.U. Member States, including Luxembourg, in light of the existence of illegal State Aid an A.T.A. or A.P.A. The European Commission has repeatedly stated that an A.T.A. or A.P.A. that merely confirms in

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<sup>5</sup> Administrative Court, July 12, 2016, no. 37448C.

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 in general illegal for E.U. Member States to grant aid on a selective basis to undertakings. The concept of aid includes the granting of tax benefits on a selective basis. If unlawful aid was granted, the European 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 European Commission has investigated A.T.A.'s issued to GDF Suez, Amazon, McDonald's and Fiat Finance and Trade ("F.F.T.") to determine whether A.T.A.'s amounted to illegal State Aid. Preliminary findings were published on October 17, 2014 regarding F.F.T., on February 6, 2015 regarding Amazon, on June 6, 2016 regarding McDonald's and on January 5, 2017 regarding GDF Suez.

On June 9, 2016, the European Commission's negative decision with regard to the F.F.T. case was published, stating that the European Commission has decided that Luxembourg granted selective tax advantages to F.F.T. The European Commission ordered Luxembourg to recover the unpaid tax from F.F.T. in order to remove the unfair competitive advantage they was 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. Luxembourg and F.F.T. have lodged an appeal against the E.U. Commission's decision with the European General Court (cases T-755/15 and T-759/15, respectively).

On October 10, 2017, the European Commission took a negative decision in the Amazon case. The decision orders Luxembourg to recover the granted state aid from Amazon. Luxembourg has since challenged the decision to the European Union General Court (case T-816/17).

## S.I.C.A.R.

The S.I.C.A.R. law provides a flexible and tax-favorable regime for any investments in risk-bearing capital. The purpose of this law is to facilitate private equity and venture capital investments within the E.U.

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

In principle, a S.I.C.A.R. organized as a capital company is fully taxable for C.I.T. purposes. However, income realized in connection with its investments in risk-bearing securities is fully exempt from C.I.T. Other income, such as interest accrued on bank deposits, management fees, and the like, is normally taxed. In a cross-border situation, the 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 and from withholding tax on dividend

distributions. Nonresident investors in a S.I.C.A.R. are not subject to Luxembourg taxes on dividends distributed or capital gains realized on the disposal of the shares in the S.I.C.A.R. A S.I.C.A.R. is subject to the minimum tax rules, as described in **Annual Net Worth Tax** above.

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

## R.A.I.F.

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

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 in **S.I.C.A.R.** 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 as:

The transaction by which a securitization vehicle acquires or assumes, directly or through another vehicle, the risks relating to claims, obligations, and other assets or to the activity of a third party by issuing securities the value or the yield of which depends on such risks.<sup>6</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

<sup>6</sup> Article 1(1) of the law of March 22, 2004 on securitization.

*"The S.I.C.A.R. law provides a flexible and tax-favorable regime for any investments in risk-bearing capital."*

*“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.”*

vehicles that set up as funds are, as a general rule, subject to prior approval and supervision by the C.S.S.F.

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

Securitization vehicles are, in principle, fully subject to Luxembourg corporation income tax at the standard combined rate of 26.01%. However, the securitization vehicle is able to deduct from its taxable base all “commitments” owed to investors and creditors. A commitment should be interpreted as including all payments 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 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 in the parent's E.U. Member State. This position is, however, not binding on the tax authorities of any other E.U. Member State or treaty country. Cross-border tax relief with respect to dividends received or distributed by a securitization company depends on the analysis made by the other E.U. Member States and treaty countries.

Securitization vehicles are exempt from net worth tax.

## RECENT AND CURRENT DEVELOPMENTS

### **Transfer Pricing 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 inspired by Article 9 of the O.E.C.D. Model Tax Convention. The legislation stipulates that upon the request of the tax authorities, the taxpayer is obliged to present relevant information underlying the transfer prices agreed upon between

associated enterprises. Based on the literal wording of Article 56, Luxembourg companies should be allowed to deduct a deemed interest expense on interest-free debt for corporation income tax and municipal business tax purposes. As there may be some doubt in this respect, an A.P.A may be sought from the Luxembourg tax authorities to obtain certainty.

The new 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 Items 8 through 10 of the B.E.P.S. Action Plan.

On December 27, 2016, the Luxembourg tax authorities published the Circular to Articles 56 and 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 million to be adequate. The Circular, however, states that the appropriate amount of equity at risk should be determined on a case-by-case basis. On the control and management of risk, the Circular refers to adequate people functions. The specific substance requirements are broadly similar to those outlined in the previous circular:

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

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

The Circular also provides for safe harbors in certain circumstances:

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



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

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

### **Developments in Exchange of Information**

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

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

Finally, on December 8, 2015, the E.U. Council adopted Directive 2015/2376/E.U. (the “E.O.I. Directive”) amending Directive 2011/16/E.U. regarding the mandatory automatic exchange of information in the field of taxation. The E.O.I. Directive 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.

### **Country-by-Country Reporting**

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

### **U.B.O. Register**

On December 6, 2017, a draft legislative bill was published 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."). The A.M.L.D. introduces a publicly-accessible register of ultimate beneficial owners, *i.e.*, the "U.B.O. Register." Transposition of the A.M.L.D. into national law was due before June 26, 2017. As of June 15, 2018, the legislation has not been adopted, but is expected to be shortly.

### **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

*“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.”*

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 continues 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.

# SWITZERLAND

## Author

Stephan Neidhardt  
Walder Wyss Ltd.  
Zürich, Switzerland

## IN GENERAL

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

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

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

## TAXATION OF HOLDING COMPANIES

### Corporation Income Tax

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

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

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

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

### **Capital Tax**<sup>3</sup>

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

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

### **Stamp Duty**<sup>4</sup>

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

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

*"A company that qualifies as a holding company for Swiss tax purposes is exempt from cantonal and communal corporation income taxes on most income – only income from Swiss real estate is ordinarily taxed."*

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

<sup>3</sup> Reductions in capital tax are within the scope of Swiss Corporate Tax Reform 2017 and T.P. 17. For possible consequences, see **Future Taxation of Swiss Holding Companies**.

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

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

### **Value Added Tax**

A Swiss holding company may be subject to V.A.T. at the present rate of 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% for Swiss securities and 0.3% for foreign securities (*i.e.*, 0.075% for Swiss securities and 0.15% for foreign securities applicable to each party that is not itself exempt or eligible for a specific exemption).

### **Swiss Withholding Tax**

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

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

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

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

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

### **Tax Credit for Foreign Withholding Taxes**

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

### **Swiss Tax Treaty Network**

Switzerland has income tax treaties with 109 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	Algeria	Anguilla	Antigua & Barbuda
Argentina	Armenia	Australia	Austria
Azerbaijan	Bangladesh	Barbados	Belarus
Belgium	Belize	British Virgin Islands	Bulgaria
Canada	Chile	China	Colombia
Croatia	Cyprus	Czech Republic	Denmark
Dominica	Ecuador	Egypt	Estonia
Faroe Islands	Finland	France	Gambia
Georgia	Germany	Ghana	Greece
Grenada	Hong Kong	Hungary	Iceland
India	Indonesia	Iran	Ireland
Israel	Italy	Ivory Coast	Jamaica
Japan	Kazakhstan	Kuwait	Kyrgyzstan
Latvia	Liechtenstein	Lithuania	Luxembourg
Macedonia	Malawi	Malaysia	Malta
Mexico	Moldova	Mongolia	Montenegro
Montserrat	Morocco	Netherlands	New Zealand
Norway	Oman	Pakistan	Peru
Philippines	Poland	Portugal	Qatar
Romania	Russia	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sri Lanka	St. Kitts & Nevis	St. Lucia
St. Vincent & the Grenadines	Sweden	Taiwan	Tajikistan
Thailand	Trinidad & Tobago	Tunisia	Turkey
Turkmenistan	Ukraine	United Arab Emirates	United Kingdom
United States	Uruguay	Uzbekistan	Venezuela
Vietnam	Zambia		

*“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.”*

New treaties with Kosovo, Brazil, Bahrain, Saudi Arabia, and Zimbabwe have been signed, but are not yet ratified.

### **1962 Anti-Abuse Decree**

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

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

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

### **1999 Circular Letter**

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

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

### **2010 Circular Letter**

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

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

Neither the 1962 Decree nor the Circular Letters of 1962, 1999, and 2010 are applicable in the context of a company having contacts with the U.S. The Switzerland-U.S.

Income Tax Treaty of 1996 overrules the application of the Swiss legislation with its extensive limitation on benefits provisions. Consequently, Swiss companies investing in the U.S. must look exclusively to the tax treaty in order to determine whether misuse exists.

### **Holding Company Activities**

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

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

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

It should be noted that the tax exemption for certain holding company activities will most likely cease once the tax reform goes into effect. This is discussed below in **Future Taxation of Swiss Holding Companies**.

### **Multilateral Instrument**

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

Initially, the Swiss income tax treaties with the following countries will be amended by the Multilateral Instrument:

Argentina	Austria	Chile	Czech Republic
Iceland	India	Italy	Liechtenstein
Lithuania	Luxembourg	Poland	Portugal
South Africa	Turkey		

These partner states are prepared to come to an agreement with Switzerland on the precise wording of the necessary amendments to the provisions of the existing

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

income tax treaties. If agreements on the technical implementation of the Multilateral Instrument can be obtained with further partner states, the corresponding income tax treaties will equally be amended by the Multilateral Instrument at a later stage. Alternatively, the B.E.P.S. minimum standards can also be implemented by means of a bilateral income tax treaty amendment.

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

The Federal Council submitted the Multilateral Instrument for public consultation on April 9, 2018. It must undergo the standard parliamentary approval process before entering into force.

## ADDITIONAL TAX-RELATED ISSUES

### **U.S. Check-the-Box Rules**

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

### **Swiss Ruling Policy**

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

All cases that do not clearly align with the tax codes or that are not based on a well-known government practice will generally be the subject of an advance ruling request by a taxpayer. Again, Swiss rulings that have an effect in a member jurisdiction of the E.U. 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 has debt from related parties in excess of the required percentages (*e.g.*, 70% for participations), the company is deemed to be thinly capitalized for Swiss tax purposes. As a consequence, the excess debt will be considered hidden equity for capital tax purposes. Interest payments on this debt are not tax deductible and will be re-qualified as deemed dividend distributions with respective Swiss withholding tax consequences.

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

### **Use of Swiss Holding Companies**

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

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

### **Future Taxation of Swiss Holding Companies**

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

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

- Beginning after 2018, the tax-free treatment of interest and other income would have ceased with the abolition of domiciliary and mixed companies and changes to the holding company regime. However, for private holding companies with only dividend income, the new law would not have led to higher taxes. Eventually, taxes might even have been lower due to the new notional interest deduction (“N.I.D.”), as described below.
- When a foreign company would have been domesticated into Switzerland



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<sup>5</sup> This policy is likely to cease on December 31, 2019 or 2020.

***“If T.P. 17 comes into effect, many Swiss cantons are expected to reduce their ordinary corporation income tax rates.”***

or a change would have occurred in a Swiss company’s tax status (e.g., the termination of a special tax status, such as holding company status), a tax-free step up to fair market value would have been allowed with regard to the basis of the assets reported on the company’s tax balance sheet. This would have resulted in an increase in the allowance for depreciation for Federal and cantonal tax purposes in Switzerland.

- A Patent Box regime would have been introduced at the cantonal tax level (and not on the Federal level), providing for privileged taxation of income from patents and similar intellectual property rights. The tax exemption could have reached up to 90% of qualifying I.P. income. The O.E.C.D.’s nexus approach for I.P. regimes would have been applied, *i.e.*, the R&D expenses would have to have been incurred through operations carried on by the Patent Box company itself.
- A super-deduction of up to 150% for Swiss R&D expenses would have been introduced at the cantonal tax level. Each canton would have been free to choose whether to enact these new R&D tax incentives.
- The N.I.D. would have been introduced on the Federal level. Cantons would have been allowed to decide whether to introduce the N.I.D. on the cantonal level. This provision would have favored companies that are highly financed with equity, as a notional interest expense deduction would have been generated by equity. If a canton had chosen to introduce the N.I.D., it would have been forced to implement a minimum taxable income inclusion of 60% for dividends received by Swiss residents from shareholdings of at least 10%. In this way, the deduction at the level of the operating company would have to be clawed back in part at the level of its shareholders owning 10% or more of the equity.
- In addition to the above, the cantons would have been free to reduce both the corporate income and capital tax rates.

Three previous proposals were withdrawn from the Corporate Tax Reform III:

- The abolition of the Federal stamp tax on equity
- The introduction of a so-called “tonnage tax” for ships registered in Switzerland
- The introduction of a general capital gains tax for individuals

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

- excludes the N.I.D.;
- includes a modified Patent Box regime, but without benefits to software companies; and
- provides an overall limitation of tax reduction at the cantonal level to 70%.

In May 2018, the parliamentary commissions amended and changed the 2017 proposal to reflect the following:

- The re-inclusion of the N.I.D. on a voluntary basis at the cantonal level, and only for so-called “high tax cantons” (*i.e.*, Zürich and Aargau)
- The increase of the tax rate on dividends for individuals who hold at least 10% of the shares in a corporation to 70% of the ordinary tax rate on the Federal level and between 50% and 70% of the ordinary tax rate on the cantonal/communal level
- If companies distribute capital contribution reserves without Swiss withholding taxes, then a compulsory distribution of ordinary dividends that is subject to Swiss withholding taxes will be necessary at the same time, in an amount equal to either 50% or 100% of the distributed capital contribution reserves

The Swiss Parliament will debate and discuss the entire proposal in the summer and fall of 2018. A decision on T.P. 17 is expected before year-end, and thereafter another referendum may be held for the Swiss people to vote on in 2019.

If T.P. 17 comes into effect, many Swiss cantons are expected to reduce their ordinary corporation income tax rates as follows (all rates include Federal income tax):

- Zug will reduce its rate from 14.62% to 12.09%
- Schwyz will reduce its rate from 15.19% to 12.51%
- Schaffhausen will reduce its rate from 15.82% to 12.01%
- Vaud will reduce its rate from 21.37% to 14%
- Geneva will reduce its rate from 24.16% to 13.49%
- Zürich will reduce its rate from 21.15% to 18.19%

The above rate reductions will also apply to Swiss holding companies that earn income other than dividend income from a subsidiary of which it owns at least 10%, since all non-dividend income will be subject to these new and lower income tax rates. Dividend income will always be subject to the participation reduction on the Federal and the cantonal/communal levels, if the parent company receiving the dividends owns at least 10% in the subsidiary. If a holding company is located in a high tax canton after the above rate reductions (*e.g.*, in the canton of Zürich), the company might consider its relocation to another canton. However, all details must be considered, including the cantonal introduction of the N.I.D.<sup>6</sup>

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<sup>6</sup> If it is introduced into law, the canton of Zürich is expected to introduce the N.I.D.

## NETHERLANDS

### Author

Ewout van Asbeck  
Van Doorne  
Amsterdam, The Netherlands

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

- Access to an extensive tax treaty network, as well as access to a large network of bilateral investment treaties (each consisting of almost 100 treaties)
- The Dutch tax ruling practice
- 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.

In 2017, as part of a plan to strengthen the Dutch investment climate and promote real economic activities, the newly-elected Dutch government published several new measures. Inter alia, the government announced plans to reduce the Dutch corporation tax rates as well as largely abolish the dividend withholding tax.

### CORPORATION INCOME TAX – GENERAL

In principle, all income of a holding company will be subject to Dutch corporation income tax at the rate of 25% for profits exceeding €200,000. Profits up to €200,000 are taxed at a rate of 20%. In October 2017, the government announced plans to reduce the Dutch corporation income tax rates as follows:

- In 2019, the rate will reduce to 19% for profits up to €200,000, and 24% thereafter.
- In 2020, the rate will reduce to 17.5% for profits up to €200,000, and 22.5% thereafter.
- In 2021, the rate will reduce to 16% for profits up to €200,000, and 21% thereafter.

### 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

*“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.”*

Dutch corporation income tax, while capital losses are deductible only under special circumstances (see **Capital Losses** below). No minimum holding period is required, although in a short term buy-and-sell transaction, part of the tax exempt capital gains realized may be re-qualified as a taxable service fee. The participation exemption only applies if the interest held by the Dutch-resident taxpayer qualifies as a participation (“*deelneming*”). A participation exists if one of the following criteria is met:

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

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. See **Hybrid Loans and Profit Rights** below. Similarly, if a Dutch taxpayer (i) holds a 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 in **Base Erosion** below.

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) the assets of the other company do not consist, directly or indirectly, of more than 50% of so-called low-taxed free passive assets (the “Asset Test”).

### **Motive Test**

In principle, a participation is considered to be held as a mere passive investment if the shareholder’s objective is to obtain a return that may be expected from normal active asset management. If the shareholder has a mixed motive, the predominant motive is decisive. A participation is not considered to be held as a mere passive investment, if the business conducted by the 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 the assets of the underlying company usually do not consist, directly or indirectly, of more than 50% low-taxed, free passive assets. For this purpose, the assets must be considered at fair market value. The term “usually” implies that the participation exemption remains applicable if the assets of the participation consist of more than 50% of low-taxed, free passive assets for a short period of time only. An example would be where a subsidiary sold its business and holds investment-grade securities until a new business is acquired.

Assets qualify as free passive assets in the following circumstances:

- The assets are passive assets that are not necessary for the business activities of the holder. Interest-bearing bank accounts, loan receivables, and passive investments such as bonds and shares, could qualify as free passive assets. In this respect, it should be noted that real estate – including rights over real estate – is not considered to be a free passive asset, unless the real estate is held by a Dutch exempt investment institution or a Dutch zero-taxed investment institution.
- The assets are 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 out of low-taxed, free passive assets, all assets – excluding participations – of the company can be allocated to the participation as “good assets.”

Free passive assets of the participation qualify as “bad assets” only if they are considered to be low-taxed. This is generally the case if the income derived from these assets is not subject to a realistic levy according to Dutch tax standards. A similar approach to the Subject-to-Tax Test applies for this purpose.

### **Earn-Out and Balance Guarantee Arrangements**

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

*“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.”*

- 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 paid on a hybrid loan will be exempt from Dutch corporation income tax and Dutch dividend withholding tax in the hands of a Dutch-resident lender if this lender owns a qualifying participation in the borrower or if the borrower qualifies as a related entity of the lender. See **In General** under **Participation Exemption** above.

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

### **Partitioning Reserve**

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

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

## **OTHER ASPECTS**

### **Costs and Expenses**

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

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<sup>1</sup> For further explanation regarding dividend withholding tax, see **Dividend Withholding Tax**.

## **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 borrowing to pay a dividend, to make an acquisition, or to make a contribution to capital. The base erosion provisions contain an exception under which the interest deduction will be granted if the taxpayer can demonstrate either of the following:

- Both the granting of the loan and the business transaction are based on sound business reasons; 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 facts exist:

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

## **Excessive Debt Financing for Holding Companies**

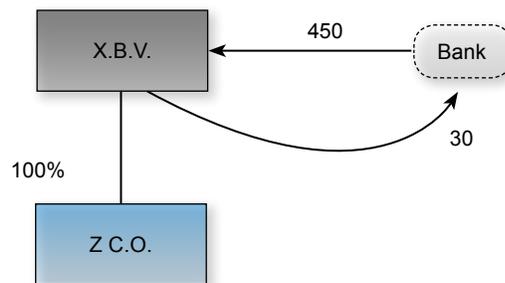
In addition to the foregoing base erosion regulations, a restriction was placed on the deduction of “excessive” interest on loans taken up in connection with the acquisition and financing of participations qualifying for the Dutch participation exemption. Article 13L of the C.I.T.A. limits the deduction of interest on so-called participation debt. Participation debt is defined as the difference between the cost of the participation and the taxpayer’s equity for tax purposes. The interest that is



proportional to the ratio of the participation debt and the company's total amount of debt is deemed to be excessive and nondeductible to the extent that the interest paid exceeds €750,000.

The limitation can be explained through the following example:

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



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

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

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

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

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

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

### **Dutch Acquisition Holding Company**

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

### **Earnings Stripping**

As of January 1, 2019, interest deductions will be limited further by the implementation of the Anti-Tax Avoidance Directive (“A.T.A.D. 1”). The Netherlands has proposed the introduction of provisions that are stricter than A.T.A.D. 1’s minimum standards. According to these provisions, the deduction of net borrowing costs will be limited to the highest of

- 30% of the company’s earnings before interest, taxes, depreciation and amortization (“E.B.I.T.D.A.”); and
- an amount of €1 million (instead of the €3 million limit required by A.T.A.D. 1).

The Netherlands will not implement a “group ratio escape rule.”

In connection with the introduction of A.T.A.D. 1, some of the existing Dutch interest deduction restrictions will be abolished in the coming years. It is expected that Tax Plan 2019 will indicate which of the restrictions may be affected.

*“In October 2017, the Dutch government announced plans to largely abolish the Dutch dividend withholding tax by January 1, 2020.”*

## **Innovation Box**

In order to stimulate research and development activities by Dutch taxpayers, self-developed registered patents and certain other assets for which a so-called research and development statement has been requested, apart from expensing costs related to R&D activities in the year incurred, (collectively, “R&D Assets”) may be placed in a so-called Innovation Box. Pursuant to the Innovation Box regime, a 7% effective tax rate<sup>2</sup> 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 7% effective tax rate will apply only to qualifying income. The non-qualifying income will continue to be subject to tax at the statutory rates of 20% and 25%.

The Innovation Box regime applies to income received from related and unrelated parties. The facility contains a threshold to prevent taxpayers from deducting expenses at the statutory rate while the corresponding earnings are taxed at the reduced effective rate of 7%. For this reason, the qualifying earnings should exceed the threshold before the effective tax rate of 7% 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 amendments to 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>3</sup> or (ii) qualify as software.
- More extensive documentation and administrative requirements have been introduced.
- Grandfathering rules will apply up to July 1, 2021 for innovations that were produced before June 30, 2016 and that were already benefiting from the

<sup>2</sup> Raised from 5% as of December 31, 2017.

<sup>3</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.

Innovation Box at that time.

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

### **Capital Losses**

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

### **Tax Treaty Network**

The Netherlands has a robust tax treaty network with more than 90 countries. The jurisdictions with which the Netherlands has a tax treaty currently in force as of May 15, 2018 are listed in the table below.

Albania	Argentina	Armenia	Aruba
Australia	Austria	Azerbaijan	B.E.S. Islands
Bahrain	Bangladesh	Barbados	Belarus
Belgium	Bermuda	Bosnia & Herzegovina	Brazil
Bulgaria	Canada	China	Croatia
Curaçao	Czech Republic	Denmark	Egypt
Estonia	Ethiopia	Finland	France
Georgia	Germany	Ghana	Greece
Hong Kong	Hungary	Iceland	India
Indonesia	Ireland	Israel	Italy
Japan	Jordan	Kazakhstan	Kosovo
Kuwait	Latvia	Lithuania	Luxembourg
Macedonia	Malaysia	Malta	Mexico
Moldova	Montenegro	Morocco	Netherlands Antilles
New Zealand	Nigeria	Norway	Oman
Pakistan	Panama	Philippines	Poland
Portugal	Qatar	Romania	Russia
Saudi Arabia	Serbia	Singapore	Slovakia
Slovenia	South Africa	South Korea	Spain
Sri Lanka	St. Martin	Suriname	Sweden
Switzerland	Taiwan	Tajikistan	Thailand
Tunisia	Turkey	Uganda	Ukraine
United Arab Emirates	United Kingdom	United States	Uzbekistan
Venezuela	Vietnam	Zambia	Zimbabwe

### **Multilateral Instrument**

As part of the B.E.P.S. Project, the Multilateral Instrument, or “M.L.I.,” was introduced. The M.L.I. aims to prevent international tax avoidance and improve coordination

between tax authorities. The Netherlands became a signatory to the M.L.I. in June 2017. The ratification of the M.L.I., including a list of reservations and notifications, is currently pending in Dutch Parliament. Depending on when the instruments of ratification are deposited, for some treaties, the M.L.I. could take effect as early as January 1, 2019.

## TAX RULINGS

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

- At least half of the managing directors reside or are established in the Netherlands.
- The company's Dutch-resident managing director(s) have sufficient professional knowledge to perform their duties.
- The company has personnel qualified for the proper execution and registration of the planned transaction.
- All management board meetings are held in the Netherlands and are in principle attended by all board members.
- All decisions of the management board should be prepared and executed in the Netherlands.
- The bank account(s) of the company are managed and maintained in or from the Netherlands.
- The Dutch-resident managing director(s) should be solely authorized to approve all transactions on the company's main bank account(s).
- The bookkeeping of the company is done in the Netherlands.
- The company's address is in the Netherlands.
- The company is not considered to be resident of another country.
- The company runs real risks with respect to its financing, licensing, or leasing activities.
- The company finances its participations with a minimum of 15% equity.<sup>4</sup>

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

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<sup>4</sup> Even when an advance tax ruling is not obtained, it is advisable to maintain a (non-statutory) debt-to-equity ratio of 85/15.

## 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 by a 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 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

- the corporate shareholder is a tax resident of a country within the E.U. or E.E.A.;
- the Dutch participation exemption would have been applicable to the shareholding in the Dutch entity distributing the dividends 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; and
- the corporate shareholder is the beneficial owner of the dividends.

Furthermore, the scope of the dividend withholding tax exemption was broadened on January 1, 2018, as the above exemption will also be available if a nonresident corporate shareholder meets these requirements and is a tax resident of a third country (*i.e.*, a country that is not an E.U. Member State) with which the Netherlands has concluded a tax treaty containing a provision covering dividends.

The income tax treaty between the Netherlands and the U.S. provides, *inter alia*, for a full exemption from dividend withholding tax if the U.S. parent company owns 80% or more of a Dutch company and certain other requirements are met. As a consequence of this change, an exemption will now be available to U.S. companies entitled to treaty protection that hold 5% or more of the shares of a Dutch company.

An additional new anti-abuse rule provides that the dividend withholding exemption does not apply at the source if

- 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 (the “subjective test”); and
- the structure or transaction is considered artificial and not set up for valid business reasons (the “objective test”).

A structure or transaction is considered artificial if and to the extent that 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,

“A 7% 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.”

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 Dutch minimum substance requirements as if it were a resident of the Netherlands. The requirements have been tightened for intermediate holding companies as of April 1, 2018. The following additional tests, alongside the Dutch minimum substance requirements discussed in **Tax Rulings** above, must be met for substance to exist:

- The intermediate holding company must incur €100,000 in salary expenses for competent, not merely supporting, staff.
- The intermediate holding company has a fully-equipped office space at its disposal for at least 24 months.

If based on the above-mentioned anti-abuse provisions the dividend withholding tax exemption will not be applicable, then the provisions of an applicable tax treaty may still be followed.

It should be noted that in October 2017, the Dutch government announced plans to largely abolish the Dutch dividend withholding tax by January 1, 2020, except for in the case of abuse situations and dividend distributions to affiliated companies or to individuals located in low-tax jurisdictions. It is as of yet unclear which situations are considered to be abusive, when a company or individual will be deemed to be “affiliated,” and what falls under the scope of “dividend distributions to low-tax jurisdictions.” In connection herewith, the Dutch government intends to introduce a withholding tax on interest and royalty payments to affiliated entities located in “low-tax jurisdictions.” The expected date of implementation of the withholding tax on interest and royalties is January 1, 2021.

## EXTRA-TERRITORIAL TAXATION AND ANTI-ABUSE RULES

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

- The nonresident company holds 5% or more of the shares, or class of shares, of the Dutch holding company (a “Substantial Shareholding”), with a main purpose of, or one of the main purposes being, to avoid the levy of Dutch income tax, dividend withholding tax, or both, with respect to another person.
- There is an artificial arrangement or a series of artificial arrangements.
- The artificial arrangement or series of artificial arrangements are similar to the artificial structure or transactions described in **Dividend Withholding Tax** above.

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

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

## CAPITAL TAX AND STAMP DUTIES

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

## B.E.P.S.

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

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

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

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



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

With the C.C.T.B., the European Commission aims to standardize the corporate tax base calculations among E.U. Member States. Whether or not these proposals will be adopted, and how and when they will be implemented by the E.U. Member States, are questions for which no certain answers currently exist.

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

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

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

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

## STATE AID

In recent years, the European Commission has started investigating whether certain individual tax rulings between companies and local authorities are in breach of E.U. State Aid rules. In some of these cases, the European Commission has already handed down final decisions concluding that certain tax rulings are in fact illegal State Aid. Two of these State Aid decisions concern Dutch tax rulings issued to Starbucks and IKEA.

It is expected that the European Commission will also investigate other tax rulings. However, the European Commission has explicitly stated that it does not expect to encounter systematic irregularities in Dutch tax rulings. The Dutch government has also taken the position that its tax ruling practice in general does not allow for State Aid so long as they do not deviate from Dutch tax law.

## IRELAND

**Author**  
James Somerville  
A & L Goodbody  
Dublin, Ireland

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

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

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

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

## RECENT DEVELOPMENTS

### **Update on Ireland's International Tax Strategy**

In tandem with Budget 2018, the Irish government published an update in October 2017 on continuing progress in modifying the Irish international tax strategy over the course of 2017. Ireland was one of the first ten jurisdictions to be assessed 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 is a signatory to 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 and fourth revisions of the Directive on Administrative Cooperation ("D.A.C.") and is actively supporting work at the E.U. level on the fifth iteration. A sixth iteration of D.A.C., which is expected to take effect in 2018, will require 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 is one of only three E.U. Member States that has 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.

### **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 the O.E.C.D. concluded ring-fenced solutions are not appropriate.
- **Action Item 2 (Hybrid Mismatches), Action Item 3 (C.F.C. Rules), and Action Item 4 (Interest Deductions):** Ireland is not proposing any legislative change at present.
- **Action Item 5 (Harmful Tax Practices):** As a pre-emptive action, Ireland moved to phase out the so-called "double Irish" tax structure in 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.
- **Actions Items 8, 9, and 10 (Transfer Pricing):** Recommendation 6 of the Review of Ireland's Corporate Tax Code stated that "Ireland 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."
- **Action Item 13 (CbC Reporting):** Ireland signed the O.E.C.D.'s multilateral competent authority agreement in January 2016 and separately introduced Country-by-Country Reporting legislation in Finance Act 2015.

- **Action Item 15 (Multilateral Instrument):** Ireland played its part in the negotiations leading to the adoption of the Multilateral Instrument on November 24-25, 2016. Ireland was one of the first countries to sign the M.L.I. in June 2017, and in Finance Act 2017 Ireland took its first step in giving legislative footing to its M.L.I. choices.

### **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. 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.

### **State Aid Investigation**

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

The European Commission published its much-anticipated decision on the Apple case on December 19, 2016, against which both Apple and the Irish government have lodged appeals with the Court of Justice of the European Union. The Department of Finance conducted negotiations with Apple over setting up a holding account for the €13 billion the European Commission says is due to Ireland in back taxes, pending the outcome of the appeals. In October 2017, the European Commission indicated it was taking Ireland to the E.C.J. over delays in recovering the money. In May 2018, Apple paid €1.5 billion into an escrow account set up by the Irish government. The payment is the first of a series, with the expectation that the remaining tranches will flow into the fund during the second and third quarters



of 2018. 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 be invested in a managed account in order to maintain its value.

### **A.T.A.D.**

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

Ireland is engaged in a consultation process on certain provisions of A.T.A.D. For example, Article 6 of A.T.A.D. requires the transposition of a G.A.A.R. by January 1, 2019. As Ireland already has a robust G.A.A.R., consultation has been sought on what changes (if any) are needed to ensure Ireland meets the minimum standards required. Similarly, consultation has been sought regarding Article 7, which requires E.U. Member States to implement C.F.C. rules by January 1, 2019.

### **A.T.A.D. 2**

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

## **CORPORATE TAX RATE**

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

The applicable rate of Irish tax on passive income is 25%. (Dividends, however, may be taxed at the 12.5% rate, depending on the circumstances, as discussed

*“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.”*

in **Dividends Paid by Irish Holding Companies** below.) This rate of tax is low compared with other jurisdictions. In addition, Ireland’s double tax treaty network is likely to give a credit for overseas tax.<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.

## DIVIDENDS RECEIVED BY IRISH COMPANIES

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

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

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

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

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

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

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<sup>1</sup> Ireland has signed double taxation treaties with 77 countries, 76 of which are in effect.

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

## DIVIDENDS PAID BY IRISH HOLDING COMPANIES

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

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

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

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

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<sup>2</sup> Where there is a chain of ownership, the exemption does not apply if an Irish-resident company is in the chain.

now applies, under which a nonresident company provides a declaration and certain information to the dividend-paying company or intermediary to claim exemption from dividend withholding tax. The declaration extends for a period of up to six years, after which a new declaration must be provided for the dividend withholding tax exemption to apply.

## EXEMPTION FROM CAPITAL GAINS TAX ON THE SALE OF FOREIGN SHARES

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

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

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

## FINANCING THE IRISH HOLDING COMPANY – INTEREST PAYMENT DEDUCTIONS

Until the A.T.A.D. rules come into effect in 2019,<sup>3</sup> Ireland does not have thin capitalization rules. Therefore, an Irish holding company can be financed principally by way of debt. An Irish tax deduction is potentially available for interest on monies

<sup>3</sup> See A.T.A.D.



borrowed to finance the acquisition of shares. Interest is allowed as a deduction if it is used in acquiring any part of the ordinary share capital of

- i. a trading company;
- ii. a company whose income consists mainly of real estate rental income;
- iii. a direct holding company of a company referred to in (i) or (ii) above;
- iv. a company whose business consists wholly or mainly of holding stocks, shares, or securities of a company referred to in (i) above indirectly through an intermediate holding company or companies; or
- v. a company whose business consists wholly or mainly of the holding of stocks, shares, or securities directly in a company referred to in (ii) above.

A deduction is also allowed for interest on funds lent to these companies, if the funds are used wholly and exclusively for the purposes of the borrower's trade or business, or that of a company connected with it.

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

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

## FINANCING OF THE IRISH HOLDING COMPANY – INTEREST WITHHOLDING TAX

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

*“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.”*

### TREATY NETWORK

Ireland has signed double taxation agreements with 77 jurisdictions, listed below, 76 of which are currently in effect (*i.e.*, excluding Ghana).

Albania	Armenia	Australia	Austria
Bahrain	Belarus	Belgium	Bosnia & Herzegovina
Botswana	Bulgaria	Canada	Chile
China	Croatia	Cyprus	Czech Republic
Denmark	Egypt	Estonia	Ethiopia
Finland	France	Georgia	Germany
Greece	Ghana	Guernsey	Hong Kong
Hungary	Iceland	India	Isle of Man
Israel	Italy	Japan	Jersey
Kazakhstan	Kuwait	Latvia	Lithuania
Luxembourg	Macedonia	Malaysia	Malta
Mexico	Moldova	Montenegro	Morocco
Netherlands	New Zealand	Norway	Pakistan
Panama	Poland	Portugal	Qatar
Romania	Russia	Saudi Arabia	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Spain	Sweden	Switzerland
Thailand	Turkey	Ukraine	United Arab Emirates
United Kingdom	United States	Uzbekistan	Vietnam
Zambia			

Irish-resident companies are taxable on their worldwide income. The treaties avoid double taxation by providing for a credit for foreign tax imposed, whether directly or indirectly, on the income received by the Irish company. The credit is allowable only against the Irish tax on the same income. Notably, Irish domestic

law grants a tax treatment more favorable than that given by the treaties.<sup>4</sup>

## CAPITAL DUTY

Capital duty is no longer imposed on a company with regards 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).

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

Ireland currently has no C.F.C. rules, although this will change with the implementation of the relevant A.T.A.D. provisions in Ireland, which must be introduced by January 1, 2019. Apart from the recharacterization rules under which interest may be treated as a dividend, and certain anti-avoidance provisions restricting interest deductibility in certain intra-group debt scenarios, Ireland does not have thin capitalization rules.

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

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<sup>4</sup> See **Dividends Paid by Irish Holding Companies**, above, regarding tax credits for foreign dividends.

respect to arrangements agreed on or after July 1, 2010.

## 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.

*“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.”*

## SPAIN

### Author

Guillermo Canalejo Lasarte  
Uría Menéndez  
Madrid, Spain

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

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

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

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

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

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

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

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

## EXEMPTION ON QUALIFIED DOMESTIC- AND FOREIGN-SOURCE INCOME

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

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

## QUALIFIED DOMESTIC AND FOREIGN INVESTMENTS

According to Articles 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 exempt from Spanish taxation if the following requirements are met:

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

**“Both dividends obtained from qualified domestic and nonresident subsidiaries and capital gains realized on the transfer of the shares held by the E.T.V.E. in qualified domestic and nonresident subsidiaries are exempt from Spanish corporation income tax.”**

## **Minimum Stake and Holding Period**

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

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

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

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

## **Subject to and Not Exempt from Tax**

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

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

Finally, nonresident subsidiaries located in one of the following tax haven countries or territories (as established by Royal Decree 1080/1991, as amended) do not

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

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

qualify for the E.T.V.E. tax exemption regime:<sup>3</sup>

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

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

### **Active Nonresident Subsidiary**

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

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

### **Qualified Holding Company**

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

- The corporate purpose of the Spanish company includes, among other activities, the holding of stakes in operating nonresident entities.
- The Spanish company carries out its activities with the necessary human and

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

<sup>4</sup> Article 5 of the C.I.T. Law.



material resources; bear in mind that non-active companies, as described in Article 5 of the C.I.T. Law, will not qualify for the E.T.V.E. regime.

- The shares or quotas of the E.T.V.E. are in registered form. Pursuant to a ruling of the Spanish tax authorities, Spanish listed companies may opt for the regime.
- The Spanish holding company informs the Spanish tax authorities that it opts to be subject to the provisions of the Spanish holding company regime.

### **Corporate Purpose**

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

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

### **Material and Human Resources**

This requirement is closely related to the previous requirement.

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

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

It is not necessary that the E.T.V.E. control and manage the activities of the invested companies. All that is required is the control and management of the stake.

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

## **Filing with the Spanish Tax Authorities**

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

## **Deduction of Costs**

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

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

## **LIQUIDATION LOSSES**

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

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

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

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

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

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

is completed.<sup>5</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.

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

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

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

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

Also, in an income tax treaty context, capital gains on the disposal of shares in an E.T.V.E. will generally not be subject to Spanish taxation. Some income tax treaties ratified by Spain, such as the income tax treaty with the U.S.,<sup>6</sup> allow Spain to tax

***“Dividends distributed by an E.T.V.E. to nonresident shareholders out of qualified exempt income . . . will not be subject to Spanish dividend withholding tax.”***

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

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

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

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

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

capital gains at the general 19% tax rate, provided that the foreign shareholder holds a substantial stake in the Spanish entity (usually more than 25% of the capital).

Finally, there are some additional domestic exemptions available to E.U.-resident shareholders, who will also benefit from an exemption on capital gains triggered by the disposal of a stake in an E.T.V.E. (or any other Spanish-resident company). The exemption applies when the E.T.V.E. does not derive its value, whether directly or indirectly, mainly from real estate located in Spain. In addition, if the E.U. resident is an individual, he or she must not have held an equity interest of 25% or more at any time during the 12-month period preceding the disposal of the interest. If the E.U. resident is an entity, the participation exemption requirements set out in Article 21 of the C.I.T. Law must be met with respect to the E.T.V.E. These requirements were previously explained, above.

## LIQUIDATION OF AN E.T.V.E.

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

## OTHER INCOME TAX ISSUES

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

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

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

## CORPORATION INCOME TAX

### Rate

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

## **Interest Barrier Rule**

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

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

## **Other Nondeductible Expenses**

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

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

## **Payments on Account Against C.I.T.**

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

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

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

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

adjustments, such as tax exemptions or tax credits).<sup>8</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 earning of the E.T.V.E.'s income to the last month of the taxable year, because the last month of the period is not covered by a payment on account.

### **Capital Duty**

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

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

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

### **Transfer Pricing**

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

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

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

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

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<sup>8</sup> The conformity of this amendment and minimum payment with constitutional principles is questionable.

**“Spanish tax authorities have been encouraging taxpayers to submit A.P.A. proposals.”**

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

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

With respect to international transactions, the regulations adopt a special procedure for a four-party agreement between the Spanish tax authorities, the tax authorities of the other country, the Spanish taxpayer, and its foreign affiliate.

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

### **Controlled Foreign Corporations**

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

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

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

### **Recent B.E.P.S. Developments**

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

- Interest on intra-group profit participation loans will be treated as equity instruments for tax purposes. The profit participation interest will no longer be tax deductible for the borrower and exempt for the Spanish-resident lender. The tax treatment for the non-Spanish resident lender remains unclear.
- Interest and other expenses accrued with respect to payments to related parties will not be tax deductible if (i) the payment is subject to different characterization in the hands of the recipient for tax purposes in its country of residence, and (ii) as a result, the recipient of the payment does not recognize any taxable income or such income is exempt from tax or taxed at a rate that

is less than a 10% nominal rate.

Dividends received from foreign subsidiaries will not be entitled to the participation exemption to the extent that the dividend distribution has triggered a tax-deductible expense in the foreign subsidiary.

### **Transposition of the A.T.A.D.**

Although most of the measures laid down in A.T.A.D. are already found in Spanish C.I.T. law, Spain is expected to make some amendments to its laws to fully align the two by the end of 2018.



# UNITED KINGDOM

## Author

Eloise Walker

Pinsent Masons LLP

London, United Kingdom

## INTRODUCTION

This summary of U.K. law is correct as of June 4, 2018.

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 prior to April 6, 2017, the following rates of R.B.C. applied:

- **£90,000:** Applicable to Non-Doms that have been resident in the U.K. for 17 of the last 20 tax years (the “17-year test”)
- **£60,000:** Applicable to Non-Doms that do not meet the 17-year test but have been resident in the U.K. for 12 of the last 14 tax years (the “12-year test”)
- **£30,000:** Applicable to Non-Doms that do not meet the 12-year test but have been resident in the U.K. for seven of the last nine years

When the R.B.C. was first introduced, it applied as a single £30,000 charge for individuals resident in the U.K. for seven of the last nine years. Since then, the R.B.C. has been amended and increased several times, in various attempts to restrict tax benefits for individuals that have been resident in the U.K. for an extended period. Consequently, different levels of the R.B.C. may apply for individual tax years between April 2008 and April 2017.

In July 2015, the government announced wide-ranging changes to the rules on domicile. 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

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and are taxed in the U.K. on their worldwide income and gains. As a result, the £90,000 R.B.C., which applies under the 17-year test, become redundant as of April 2017.

Legislation to introduce these changes was included in the second Finance Act 2017 that received Royal Assent on November 16, 2017.

An important R.B.C. relief was introduced in 2012. As of April 2012, foreign income and gains may be brought into the U.K. for the purpose of investing in certain U.K. companies without constituting a taxable remittance that is subject to U.K. tax. The relief applies to investments in private U.K. companies only. Broadly, the investment can be made by way of shares or debt and must be made within 45 days of the funds being brought into the U.K. The relief will not be available where the funds are being remitted as part of a scheme or arrangement to avoid U.K. tax.

It should be noted that during the summer of 2016, the U.K. government consulted on possible changes to this relief, in order to further encourage investment in U.K. companies by Non-Doms. These changes were introduced in Finance (No. 2) Act 2017, which was introduced after the U.K.'s general election in June 2018 and takes effect from April 6, 2017.

Foreign executives coming to work in the U.K. should also be aware of certain measures, introduced in Finance Act 2014, to combat the misuse of artificial dual contracts by non-domiciled employees. Broadly, the rules prevent U.K.-resident Non-Doms from electing to use the remittance basis for overseas employment income where these individuals are artificially separating U.K. and overseas employment duties by creating separate employment contracts with a U.K. employer and an associated overseas employer.

A statutory residence test ("S.R.T.") was introduced in April 2013 to determine whether an individual is tax resident in the U.K. The S.R.T. is designed to give individuals greater certainty and clarity as to whether they are tax resident in the U.K. and therefore subject to U.K. income tax and capital gains tax ("C.G.T.") on their worldwide income and gains. Individuals should note that their tax residence status under the S.R.T. may differ from their tax residence in years prior to the introduction of the S.R.T.

## **Corporations**

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

- The U.K. has competitive corporate income tax rates. The main rate of U.K. corporate income tax is currently 19% (reduced from 20% in April 2016). The main rate of U.K. corporate income tax is due to be further reduced to 17% in April 2020.
- An exemption from corporate income tax is available for most dividends received from U.K.- and foreign-resident companies, and is backed up by a foreign tax credit system where the exemption does not apply.
- No withholding tax is levied on dividends paid by U.K. companies to nonresident shareholders, except for distributions made by certain types of investment funds, such as real estate investment trusts ("R.E.I.T.'s").

*“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.”*

- The U.K. offers an exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups. However, it should be noted that during 2016, the U.K. government consulted on changes to the substantial shareholding exemption. Legislation effecting changes was introduced in Finance (No. 2) Act 2017 and took effect from April 1, 2017. There is no C.G.T., in general, on the sale of shares in U.K. companies by nonresidents.
- There are no capital taxes on formation or paid-in capital of companies.
- The U.K. has an optional “Patent Box” regime, introduced in April 2013 as part of the U.K. strategy to incentivize innovation, and the development and retention of certain intellectual property rights in the U.K. Broadly, the regime allows qualifying companies to elect to apply a lower rate of U.K. corporate income tax on all profits attributable to qualifying patents, whether paid as royalties or embedded in the price of the products. The relief was phased in over five years, and as of April 1, 2017 provides an effective corporate income tax rate of 10% on worldwide profits attributable to qualifying patents and similar I.P. rights. However, the Patent Box was closed to new entrants after June 30, 2016 and will be abolished for existing claimants by June 30, 2021. Developments to the Patent Box regime follow recommendations from the O.E.C.D. published in October 2015. From July 1, 2016, a new U.K. “Patent Box” became available that is based on the “modified nexus” approach. This approach looks more closely at the jurisdiction where the R&D expenditure incurred in developing the patent or product actually takes place. It seeks to ensure that substantial economic activities are undertaken in the jurisdiction in which a preferential I.P. regime exists, by requiring tax benefits to be connected directly to the R&D expenditure. Further changes to the new Patent Box regime were introduced in Finance (No. 2) Act 2017 to ensure that 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 and are not 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 on or after April 1, 2013. The R.D.E.C. is calculated directly as a percentage of the company’s R&D expenditure and subsidizes the R&D. The credit is recorded in a company’s accounts as a reduction in the cost of R&D – that is, it is recorded above the tax line. For large companies, the R.D.E.C. is payable at 11%. A separate regime allowing for a tax deduction of 230% of qualifying R&D expenditure for small- or medium-sized companies (“S.M.E.’s”) is also available provided certain conditions are met.
- The U.K. has the most extensive tax treaty network in the world, covering around 130 countries.
- There has been official confirmation that the U.K. will not introduce a financial transactions tax (“F.T.T.”). It remains a possibility that the E.U. will introduce an F.T.T. Irrespective of the fact that the U.K. is expected to have withdrawn from the E.U. by March 2019, the U.K. had previously announced that it would not introduce a F.T.T. unless it was introduced on a global basis in order to safeguard the competitiveness of the U.K.’s financial services market.

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

- the *Franked Investment Income/Foreign Dividend Group Litigation*<sup>1</sup> (see below),
- the *Cadbury Schweppes plc v. H.M.R.C.*<sup>2</sup> (see below), and
- the *Thin Cap Group Litigation*.<sup>3</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”).

Another notable C.J.E.U. decision that affects the U.K.’s status as a holding company jurisdiction is the *Marks & Spencer plc v. Halsey* decision.<sup>4</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.

Despite the fact that the U.K. will formally leave the E.U. by March 2019 at the latest, to maintain legal certainty, it is currently anticipated that all existing E.U. law, including previous decisions by the C.J.E.U., will continue to apply to the U.K. after the point of its withdrawal.

## CORPORATE INCOME TAX RATE

As previously noted, the main rate of U.K. corporate income tax is 19%. This rate is currently due to be reduced to 17% from April 2020.

### **U.K. Companies**

A company tax resident in the U.K. is liable to U.K. corporate income tax on its worldwide income and gains. Generally, capital gains realized by a U.K. company

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<sup>1</sup> *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, Case C-446/04 [2006] E.C.R. I-11753.

<sup>2</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>3</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>4</sup> *Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes)*, Case C-446/03, [2005] E.C.R. I-10837.

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 in the case of companies whose shares are listed on an exchange in the E.U. Generally, capital gains are taxed on realization.

### **Non-U.K. Companies**

Generally, a company that is not tax resident in the U.K. is liable to U.K. tax only on certain items of U.K.-source income and gains, such as rental income. Most other U.K. income is taxable only to the extent that U.K. tax is withheld at the source, such as on certain interest payments.

However, a non-U.K. company may still be liable for U.K. corporate income tax if it trades in the U.K. through a U.K. permanent establishment, such as a branch or agent. In this case, the nonresident company would be liable for U.K. tax on worldwide income and gains related to that permanent establishment.

Certain non-U.K. companies (and other U.K. and non-U.K. “non-natural persons”) that hold certain high-value (*i.e.*, over £500,000) U.K. residential real estate assets are subject to an annual charge (the “annual tax on enveloped dwellings” or “A.T.E.D.”). The A.T.E.D. amount increases as the value of the real estate asset increases. The lowest rate is currently £3,600 (for real estate valued at more than £500,000 but less than £1,000,000), whilst the top rate is currently £226,950 (for real estate valued at more than £20 million).

Originally, the A.T.E.D. only applied to residential real estate assets valued at more than £2 million, but subsequent Finance Acts have extended the scope of the tax so that the A.T.E.D. applies to residential real estate assets valued over £500,000 from April 1, 2016. There are certain reliefs from the A.T.E.D. for genuine real estate development companies and rental companies.

When an asset falls within the scope of the A.T.E.D. charge, the disposal of that asset is subject to 28% C.G.T. (“A.T.E.D.-related C.G.T.”). With respect to these disposals, U.K. companies will be liable to A.T.E.D.-related C.G.T., rather than U.K. corporate income tax.

Since April 6, 2015, corporate entities not resident in the U.K. are also subject to C.G.T. on gains accruing on the sale of all U.K. residential real estate assets (the “nonresident C.G.T. charge”). Any gain arising on or after April 6, 2015 is taxable at 20% unless the A.T.E.D.-related C.G.T. charge applies.

It is possible that a disposal may fall within the scope of both the A.T.E.D.-related C.G.T. charge and the nonresident C.G.T. charge. In such circumstances, A.T.E.D.-related C.G.T. is applied first, and then the nonresident C.G.T. charge is applied only to gains that are not subject to A.T.E.D.-related C.G.T.

*“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.”*

It should be noted that the nonresident C.G.T. charge for gains realized on disposals of U.K. residential real estate assets also applies to individuals, trustees, and personal representatives. The rate of the charge is 18% or 28% for individuals (depending on the person's overall taxable income and applicable income tax rate) and 28% for trustees and personal representatives.

At the time that the U.K.'s budget was delivered in November 2017, the U.K. government published a consultation outlining proposals to extend the nonresident C.G.T. charge to commercial real estate assets. It is intended that there will be a single regime for taxing gains realized by nonresidents on the disposal of U.K. real estate assets that will apply to both residential and commercial real estate from April 2019. It is expected that this regime will 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 has had such an 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, are exempt if that distribution (i) falls into an exemption, (ii) does not represent a payment of interest deemed to be a distribution, and (iii) does not qualify for a tax deduction with respect to a resident of any territory outside the U.K. under the laws of that territory.

The exemptions are widely drafted, and in practice, most distributions received by a company will fall under one of the following exemptions:

- **Distributions from controlled companies.** Broadly, this exemption applies when the recipient, alone or in conjunction with others, is in control of the company, in accordance with the relevant definition of control.
- **Distributions with respect to non-redeemable ordinary shares.** This exemption will cover most distributions with respect to ordinary shares by U.K. companies.
- **Distributions with respect to portfolio holdings.** Broadly, these are holdings of less than 10%.
- **Dividends derived from transactions not designed to reduce tax.**
- **Dividends with respect to shares accounted for as liabilities of the issuer under G.A.A.P.** These payments are usually taxed under different provisions.
- **Capital distributions made from reserves arising from a reduction in capital.** Distributions that are capital in nature and which fall outside of the "dividend exemption" may be subject to U.K. corporate income tax on chargeable gains, unless the substantial shareholding exemption or another exemption or relief is available.

Several anti-avoidance provisions exist to prevent artificial avoidance or manipulation of these exemptions. Targeted schemes include, *inter alia*, deductions given for distributions, payments effected on non-arm's length terms, and diversions of trade income. In addition, other anti-avoidance rules, including the general anti-abuse rule ("G.A.A.R.") (discussed in **Corporate Criminal Offenses of Failing to Prevent Tax Evasion** below), may prevent a taxpayer from claiming exemptions in certain cases.

The recipient of an exempt distribution can elect not to apply an exemption with respect to a particular distribution. The election must be made within two years of the end of the accounting period in which the distribution is received.

## FOREIGN TAX CREDIT FOR U.K. COMPANIES

Where the exemptions described above do not apply, double taxation issues may arise if a U.K. corporate recipient of a non-U.K. dividend would be subject to both U.K. tax and foreign tax in the jurisdiction from which the dividend is paid. To combat this, tax relief may be available under the provisions of a double tax treaty between the U.K. and the relevant foreign jurisdiction.

Where an income tax treaty is not in place to provide relief, a credit is generally granted against U.K. tax for foreign withholding tax levied on non-U.K. dividends. A U.K. tax credit will not be available if the relevant income tax treaty expressly denies relief in the form of a tax credit under these circumstances.

Generally, companies pay dividends out of taxed profits. If a nonresident pays foreign tax on profits out of which a dividend is paid, the foreign tax payment is referred to as an "underlying tax." In the U.K., an indirect foreign tax credit may be allowed for underlying tax where the recipient is a U.K. tax resident company (an "underlying tax credit"). Typically, this underlying tax credit will only be available where the U.K. recipient company has a substantial interest in the foreign payer.

Broadly, to meet the substantial interest standard, the recipient must directly or indirectly control, or be a subsidiary of a company that indirectly or directly controls, 10% or more of the voting power of the payer company. However, in limited circumstances, the underlying tax credit may be available where the 10% control condition is not strictly met.

For the purpose of the underlying tax credit, underlying tax will generally include underlying tax from related companies through an indefinite number of successive levels in the corporate chain. For this purpose, two companies are associated if the shareholder receiving the dividend, directly or indirectly, controls 10% or more of the voting power in the paying company. A U.K. tax credit given for foreign tax will be reduced or denied if a foreign tax authority has repaid any amount of the foreign tax paid to (i) the recipient of the U.K. tax credit, (ii) any person connected with the recipient, or (iii) a third party as a result of a scheme (which is broadly defined).

### **Source of Income**

Although the U.K. does not have a "basket" system for allocating foreign tax credits, the "source" doctrine has imposed significant restrictions on the pooling of foreign tax credits. The shares in a foreign company constitute a distinct source, and the



foreign tax may only be credited against income from that particular source. In certain cases, a particular class of shares in a company may be a distinct source.

### **Credit Pooling**

Previously, the U.K. had a relatively complex regime of “onshore pooling” of foreign tax credits, allowing excess foreign tax credits from one source to be applied against the U.K. tax due on other foreign-source dividends. However, this regime has been discontinued. In the majority of cases, there will now be no U.K. tax liability levied on the corporate recipient of an overseas dividend and, therefore, there is no need for a credit pooling system to relieve any associated U.K. tax liability.

### **Anti-Avoidance**

A broad anti-avoidance rule, specifically aimed at foreign tax credits, exists to combat arrangements designed to secure excessive foreign tax credits, such as “dividend buying” schemes, where extra income is deliberately purchased to enhance the foreign tax credit of the purchaser. The rule applies where four conditions are satisfied:

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

Broadly, schemes or arrangements are those which

- enable attribution of foreign tax, when the foreign tax is properly attributable to another source of income or gains;
- concern the effect of paying foreign tax, so that on entering the scheme it would be reasonable to expect that the total amount of foreign tax would be increased by less than the amount allowable as a tax credit;
- involve deemed foreign tax, where an amount is treated as if it were foreign tax paid and either no real foreign tax would reasonably be expected to be paid or it would be reasonable to expect that the increase in foreign tax credit allowed exceeds the increase in actual tax paid;
- concern claims or elections for tax credits the effect of which is to increase or give rise to a claim for a relief by way of a tax credit;
- would reduce a person’s tax liability; or
- involve tax-deductible payments.

H.M.R.C. will issue a counteraction notice where it has reasonable grounds to determine that the above criteria have been met. Taxpayers will then have 90 days to determine whether to (i) accept H.M.R.C.’s application of the legislation and amend their self-assessment tax return as required, or (ii) disregard the counteraction

*“There is no U.K. withholding tax on dividends paid by U.K. companies to U.S. shareholders.”*

notice. Disputes regarding the application of the rules will be resolved through the normal self-assessment examination and appeals procedure. Where the counteraction notice is successfully invoked, the tax credit claim will be limited so as to cancel the effect of the scheme or arrangement.

Different rules apply where the underlying tax of a nonresident company is involved. In such circumstances, the counteraction will apply where, had the nonresident company that paid the foreign tax been a U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company.

### **Hybrid Instruments**

In certain limited circumstances, it may be possible for a foreign dividend, which is not exempt from U.K. corporate income tax, to give rise to a tax credit for the U.K. corporate recipient and also be deductible for the foreign payer for foreign tax purposes. Where this occurs, the U.K. corporate recipient will not obtain a U.K. tax credit for underlying foreign tax. The denial of credit for underlying foreign tax is automatic and not limited to instruments created or assigned for the purpose of obtaining the benefit of the credit.

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

There is no U.K. withholding tax on dividends paid by U.K. companies to U.S. shareholders as the U.K. does not impose withholding tax on dividends to nonresident shareholders as a matter of domestic law.

However, U.K. withholding tax at 20% applies to property income distributions (“P.I.D.’s”) paid in relation to certain qualifying activities by R.E.I.T.’s that are resident in the U.K. This may be reduced by an applicable U.K. income tax treaty. A company will not be able to qualify as a R.E.I.T. if it has corporate shareholders with a 10% or greater participation. In those circumstances, tax will be withheld at the rate applicable to portfolio dividends. This rate currently is 15% for qualified U.S. residents under the U.K.-U.S. Income Tax Treaty. The position is essentially the same with respect to the 20% withholding that applies to P.I.D.’s made by property-authorized investment funds.

## **DIVERTED PROFITS TAX**

The Diverted Profits Tax (“D.P.T.”) is a U.K. tax aimed at multinationals operating in the U.K. that artificially siphon profits out of the U.K. or try to avoid a taxable establishment by playing the complexities of the tax system. It is primarily an anti-avoidance measure and was introduced in Finance Act 2015.

The current rate of D.P.T. is 25% of the diverted profit. D.P.T. is charged at a rate of 55% on ring-fenced diverted profits and ring-fenced notional profits in the oil sector. Given that the rate of U.K. corporation tax is currently 19% (and set to be reduced further), it is expected that companies affected by D.P.T. will seek to restructure operations, so as to derive profits in the U.K.

D.P.T. applies to diverted profits arising on or after April 1, 2015, although there were apportionment rules for accounting periods that straddled that date.

Broadly, D.P.T. applies in two circumstances:

- A group has a U.K. subsidiary or permanent establishment and there are arrangements between connected parties which “lack economic substance” in order to exploit tax mismatches. One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity in a tax haven.
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a permanent establishment in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax, or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. (This is referred to as the “avoidance of a U.K. taxable presence.”)

D.P.T. does not apply to S.M.E.’s.

Where companies or permanent establishments lack economic substance, there are two tests that must be considered: (i) the insufficient economic substance condition, and (ii) the effective tax mismatch condition. If either test is met, a D.P.T. charge will be payable.

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit, and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction. Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person’s involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that have a real financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party.

There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, or to certain offshore funds or authorized investment funds.

Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied, or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporate income tax charge.

***“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.”***

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 does not have to make an election in order to benefit from it.

The conditions of the S.S.E. were substantially amended following changes introduced in Finance (No. 2) Act 2017 and 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. corporation 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.
- The Seller would be beneficially entitled on a winding up to not less than 10% of the assets of the Target Company 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 amount of 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 may have been required to rely on a third-party buyer’s operation of the Target Company following the disposal. From, April 1, 2017, this condition is only relevant where

- the relevant buyer and the Seller are connected; and
- 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.

In certain circumstances, anti-avoidance provisions relating to U.K. real property may trigger a liability to income tax on the sale of shares of companies whose value is based on U.K. real estate.

## CAPITAL TAX AND STAMP DUTY

In the U.K., there is no capital tax on the formation of a company or on any capital paid in. No stamp duty is paid on share subscriptions.

Transfers of shares of U.K. companies are generally liable to stamp duty or stamp duty reserve tax (“S.D.R.T.”) at 0.5% of the consideration for the sale, albeit various exemptions may apply. For example, exemptions exist for certain intra-group transfers and transfers of shares on “recognized growth markets,” such as the Alternative Investment Market (“A.I.M.”) and the I.C.A.P. Securities & Derivatives Exchange (“I.S.D.X.”).

Technically, stamp duty is a tax on documents. Therefore, U.K. stamp duty is payable on the sale of non-U.K. shares if the transfer document is signed in the U.K. Stamp duty must be paid by the purchaser within 30 days of signing. Failure to meet this deadline can result in penalties and interest.

A higher rate of stamp duty or S.D.R.T. of 1.5% may be charged where shares and securities are issued or transferred into a clearing system or a depository receipt facility. However, this increased charge has been successfully challenged under E.U. law. Consequently, in practice, the higher charge will only apply to transfers of U.K. shares or securities into a clearing system, or depository receipt facility, if the transfer is not an integral part of an issue of share capital or raising of capital. However, the legitimacy of this higher charge and its compatibility with E.U. law, particularly the free movement of capital, remains questionable.

Finance Act 2016 contains a new provision to ensure that the transfer of U.K. securities into a depository receipt facility, or clearance system following the exercise of an option, will give rise to a 1.5% stamp duty or S.D.R.T. charge on the greater of the fair market value or option strike price, as of the date of the transfer. The new provision applies to options exercised on or after March 23, 2016.

This change 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.

## TAX TREATY NETWORK

As noted above, the U.K. has one of the most extensive tax treaty networks in the world – treaties are in effect with approximately 130 jurisdictions, listed below:

Albania	Algeria	Antigua & Barbuda	Argentina
Armenia	Australia	Austria	Azerbaijan
Bahrain	Bangladesh	Barbados	Belarus
Belgium	Belize	Bolivia	Bosnia & Herzegovina



Botswana	British Virgin Islands	Brunei	Bulgaria
Canada	Cayman Islands	Chile	China
Croatia	Cyprus	Czech Republic	Denmark
Egypt	Estonia	Ethiopia	Falkland Islands
Faroe Islands	Fiji	Finland	France
Gambia	Georgia	Germany	Ghana
Greece	Grenada	Guernsey	Guyana
Hong Kong	Hungary	Iceland	India
Indonesia	Ireland	Isle of Man	Israel
Italy	Ivory Coast	Jamaica	Japan
Jersey	Jordan	Kazakhstan	Kenya
Kiribati	Kosovo	Kuwait	Latvia
Lesotho	Libya	Liechtenstein	Lithuania
Luxembourg	Macedonia	Malawi	Malaysia
Malta	Mauritius	Mexico	Moldova
Mongolia	Montenegro	Montserrat	Morocco
Myanmar	Namibia	Netherlands	New Zealand
Nigeria	Norway	Oman	Pakistan
Panama	Papua New Guinea	Philippines	Poland
Portugal	Qatar	Romania	Russia
Saudi Arabia	Senegal	Serbia	Sierra Leone
Singapore	Slovakia	Slovenia	Solomon Islands
South Africa	South Korea	Spain	Sri Lanka
St. Kitts & Nevis	Sudan	Swaziland	Sweden
Switzerland	Taiwan	Tajikistan	Thailand
Trinidad & Tobago	Tunisia	Turkey	Turkmenistan
Tuvalu	Uganda	Ukraine	United Arab Emirates
United States	Uruguay	Uzbekistan	Venezuela
Vietnam	Zambia	Zimbabwe	

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

Broadly, the U.K. treaty negotiating position aims to

- reduce the risk of double taxation where the same income is taxable in two states,
- provide certainty of treatment for cross-border trade and investment,
- prevent excessive foreign taxation and other forms of discrimination against U.K. business interests abroad, and
- protect the U.K.'s taxing rights against attempts to evade or avoid U.K. tax.

The latter point has become a driver for U.K. tax treaty policy, consistent with E.U. and O.E.C.D. policies.



The extensive U.K. treaty network is also significant in reducing or eliminating non-U.K. taxes on payments made to recipients that are U.K. tax resident. One specific aim of U.K. treaty policy is the elimination of withholding tax on interest and royalties. About one-quarter of the U.K. treaties achieve this goal. The remaining treaties typically reduce withholding tax rates. U.K. tax treaties also commonly exempt disposals of shares from C.G.T. in the source state.

Additionally, almost all U.K. treaties reduce foreign withholding tax on dividends. In any event, where a U.K. or other E.U. company owns at least 10% of the shares in another E.U. company, the E.U. Parent-Subsidiary Directive (“P.S.D.”) operates to eliminate any withholding tax on dividends paid by the subsidiary company to the parent company. It is unlikely that U.K. companies will be able to benefit from the P.S.D. once the U.K. has left the E.U., however, this cannot be confirmed until the precise terms relating to the U.K.’s exit from the E.U. have been agreed.

Pursuant to the European Interest and Royalties Directive, intra-group interest and royalty payments may also be free of withholding tax when paid to an associated company in another E.U. Member State. Again, it is not expected that the U.K. will be able to benefit from the European Interest and Royalties Directive after it has left the E.U.

It should also be noted that following Finance Act 2016, royalty payments made between connected parties on or after March 17, 2016 are denied any benefit conferred by a U.K. double tax treaty if a main purpose of the arrangement is to secure a benefit that is contrary to the purpose of the relevant treaty. This can be viewed as an attack on holding companies that do not serve a business function separate from a reduction of withholding taxes.

## DEBT FINANCING OF U.K. COMPANIES

### **The Deductibility of Interest Expense – 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” has also been introduced that applies to arrangements entered into from November 18, 2015. The rule is very widely drafted and could potentially apply to any financing transaction where the main or one of the main purposes is to obtain a tax advantage. The rule operates to counteract any tax advantage that may result from the transaction, including an interest expense deduction. The U.K. G.A.A.R. provisions may also operate to restrict an interest deduction in certain circumstances.

A restriction on the deductibility of interest expense may also be imposed by the U.K.’s thin capitalization rules, which are contained in the transfer pricing legislation. Under these rules, an interest deduction may be disallowed in certain circumstances. Currently, the thin capitalization rules do not have fixed ratios or safe harbors regarding the extent to which interest is deductible.

In addition to the foregoing anti-abuse provisions, the operation of the U.K.’s worldwide debt cap rules also operated to impose a restriction on deductions of interest expense.

Prior to April 1, 2017, the worldwide debt cap 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. For this purpose, net U.K. debt of any company less than £3 million was disregarded.

Broadly, the total disallowed amount of the worldwide group was the excess of the aggregate relevant financing expense of U.K.-resident group companies and permanent establishments of nonresident members, over equivalent amounts of the worldwide group. In calculating the aggregate financing expense, net financing expenses of a company below £500,000 were disregarded. The disallowed amount could be allocated among relevant companies as determined by the group, but failing proper allocation, it was apportioned by formula. Where a disallowance arose, a corresponding exemption applied to the financing income of relevant companies. Financing income received could also be exempt if the payer was a tax resident of an E.E.A. territory and was denied relief for payment. Exclusions applied to financial services groups, group treasury companies, charities and exempt bodies, stranded management expenses in non-trading loan relationships, R.E.I.T.’s, foreign branches, oil extraction companies, shipping operations within the tonnage tax, property rental businesses, and intra-group short-term financing. Qualifying securitization companies were also excluded.

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, new rules apply that restrict tax deductions for corporate interest payments by reference to a fixed ratio.

**“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.”**

### Background to the New Rules – the B.E.P.S. Project

The U.K. government’s decision to restrict the tax deductibility of corporate interest payments has been driven by international pressure following the recommendations of the O.E.C.D.’s efforts to combat base erosion and profit shifting (the “B.E.P.S. Project”).

The B.E.P.S. Project aims to combat the artificial shifting of profits within a multinational group from high-tax jurisdictions to low-tax jurisdictions and the exploitation of mismatches between different tax systems that result in little or no tax being paid on a global basis. Following international recognition that the global tax system needed reforming to prevent B.E.P.S., the G-20 asked the O.E.C.D. to recommend possible solutions. In July 2013, the O.E.C.D. published an Action Plan proposing 15 actions designed to combat B.E.P.S. at an international level, which included recommendations to restrict tax relief on corporate interest payments (Action Item 4).

Action Item 4 focused on limiting B.E.P.S. via interest deductions, and specifically, on whether a general rule should be introduced to restrict the availability of tax relief on interest payments, regardless of the purpose of the debt or the party it is with.

In October 2015, the O.E.C.D. published its final recommendations in relation to Action Item 4. It recommended the introduction of a general interest limitation rule that should operate by restricting interest deductions by reference to a fixed ratio of a company’s earnings before interest, taxes, depreciation and amortization.

The O.E.C.D. did not specify the level of this ratio; rather, it advocated that countries should choose an E.B.I.T.D.A. ratio of between 10% and 30%.

The O.E.C.D. recommended that there should be an optional exclusion for interest on loans used to fund public-benefit projects. The rationale for this is that certain public benefit projects are considered to have a low tax avoidance risk.

The O.E.C.D. also recommended introducing a number of safeguards to address any potential volatility that the rule may create. These included a *de minimis* threshold for low-risk entities and carryforward provisions, whereby disallowed interest deductions may be carried forward and deducted in a future accounting period.

The O.E.C.D. also suggested that jurisdictions should consider introducing suitable transitional rules, particularly to enable existing third-party debt to be excluded or “grandfathered” from the ambit of the new restrictions.

### Overview of the New U.K. Rules

Under the new U.K. rules, 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 carried forward interest may then be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period, it can carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after five years.

The new restrictions apply to interest on existing loans as well as new loans, although limited grandfathering is available in certain circumstances (see below).

As stated above, the worldwide debt cap was repealed and replaced by new legislation that has a similar effect.

### Group Ratio Rule

The new 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.

Interest on related-party loans, perpetual loans, and results-dependent loans is not included in the calculation of the G.R.R.

Earlier drafts of the legislation had provided that a third-party loan guaranteed by a related party would constitute related-party debt, which would have resulted in many commercial loans being ineligible for the G.R.R. However, following extensive lobbying from industry, the legislation was revised and now provides that a loan will not be treated as having been made by related parties where (i) a guarantee is provided by a member of the debtor’s group, (ii) financial assistance is only provided in relation to shares in the ultimate parent entity, (iii) the loans are made to a member of the group, or (iv) the financial assistance is a non-financial guarantee. Limited grandfathering is also available for guarantees provided prior to April 1, 2017.

### Public Infrastructure Exemption

To maintain investment in the U.K.’s infrastructure sector, there 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-g 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

- tangible U.K. infrastructure assets that meet a “public benefit test”; or
- buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties.

The public infrastructure asset must also have or be likely to have an expected economic life of at least ten years, and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset 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 new 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

- loan relationships were entered into on or before May 12, 2016; and
- where at least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years was highly predictable by reference to certain public contracts.

Originally, no grandfathering was proposed. However, there were significant concerns that without it some existing infrastructure projects would go into default, particularly those with shareholder debt, such as many existing private finance initiatives or similar projects, which may find it difficult to restructure. Take, for example, infrastructure projects involving U.K. schools and hospitals that are highly geared for genuine commercial reasons and whose viability is dependent on the tax deductibility of the project's interest expense. These projects may have commenced ten years ago and may still have 20 or more years left to run; a restriction on tax relief could be catastrophic to the continued viability of such projects.

After much lobbying by industry, grandfathering was introduced for these projects. The grandfathering exemption applies to interest on loans between related parties if the conditions are satisfied.

A transitional provision also applies in the first year to enable groups to restructure to fall within the P.I.E.

#### Administration of the New Rules

The new rules operate by assessing the level of interest in the worldwide group and therefore any restriction on the deductibility of interest cannot be processed through a company's normal U.K. corporation tax return. U.K. companies 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. corporation

taxpayers.

Quoted Eurobonds also benefit from an exemption from U.K. withholding tax. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized exchange.

As explained above, bilateral tax treaties may also reduce the amount of withholding tax payable on interest payments to non-U.K. lenders. Administrative burdens arise when a reduction is claimed under a treaty.

As of January 1, 2016, an exemption was introduced for certain qualifying private placements. A private placement is a type of unlisted debt instrument that is sold by way of a private offering to a small number of investors. The exemption is intended to encourage the use of private placements as an alternative form of financing.

The exemption will apply only to a security under the loan relationship rules. Therefore, it must be a money debt, as previously discussed. The term of the security must not be more than 50 years, and the aggregate value of the securities contained in the private placement must be at least £10 million.

The exemption will be available only if the debtor holds a certificate from the creditor, confirming that (i) the creditor is resident in an approved territory and is beneficially entitled to the interest in the private placement for genuine commercial reasons, and (ii) the private placement is not being held as part of a tax avoidance scheme. Broadly, a country will be an approved territory if it has been designated as such by other U.K. tax regulations or it has a double tax agreement with the U.K. and the tax agreement has a non-discrimination article.

Debtors are also required to have entered into the private placement for genuine commercial reasons and not as part of a tax advantage scheme.

Following the introduction of Finance Act 2017, from April 6, 2017, certain open-ended investment companies (“O.E.I.C.’s”), authorized unit trusts (“A.U.T.’s”) and investment trust companies (“I.T.C.’s”) no longer have to withhold U.K. tax on interest distributions that are treated as payments of yearly interest.

## ANTI-ARBITRAGE LEGISLATION

Prior to January 1, 2017, the U.K. had legislation to counter tax avoidance using arbitrage schemes that involved *inter alia*, hybrid entities. Where the rules applied, a deduction for corporate income tax purposes was denied to U.K. companies if, and to the extent that, more than one deduction was available for the same expense, whether in the U.K. or elsewhere, and the income accruing or arising under the scheme was taxed only once.

As of January 1, 2017, the U.K.’s anti-arbitrage rules were replaced with new anti-avoidance rules, known as the “anti-hybrid rules.” These new rules are based on the O.E.C.D.’s final recommendations in relation to Action Item 2 of the B.E.P.S. Project. Action Item 2 focuses on the avoidance of tax using hybrid-mismatches. These arrangements exploit tax rules in different countries to enable a multinational to avoid paying tax in either country or to access excessive tax relief by deducting the same expense in more than one country. The U.K.’s new anti-hybrid rules are contained in Finance Act 2016. Broadly, the new rules operate to deny a U.K. tax

deduction, or 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.

## CONTROLLED FOREIGN CORPORATIONS

### **Background**

The U.K. has anti-avoidance rules to combat tax avoidance using C.F.C.'s. A C.F.C. is a company that is resident outside the U.K. for tax purposes and controlled by one or more persons resident in the U.K. The objective of the U.K.'s C.F.C. regime is to prevent the artificial diversion of U.K.-taxable profits to subsidiaries or other corporate entities in low-tax jurisdictions.

In certain circumstances, the regime operates to attribute profits of the C.F.C. to a U.K.-resident company in the form of a C.F.C. charge. In 2010, the regime was substantially amended, largely as a result of successful challenges regarding the compatibility of the regime with E.U. law.

### **Overview of the Current Regime**

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

The rules widely define the meaning of U.K.-source income for the purposes of the C.F.C. regime. There are five categories of income that are regarded as U.K.-source and they are mutually exclusive:

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

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

- shareholder control (“legal control”),
- ownership or entitlement to assets (“economic control”), and
- the treatment of the company as an undertaking by the U.K. parent for accounting purposes, even if consolidated accounts are not formally required (“accounting control”).

*“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.”*

***“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.”***

There are five exemptions that operate to either reduce or exempt the profits falling within the C.F.C. charge. These are assessed at the entity level:

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

Virtually every provision in the C.F.C. regime contains an anti-avoidance rule based on the presence of an intent to obtain the tax benefit as a principal reason for casting a transaction through a C.F.C. As indicated above, these will apply in addition to G.A.A.R.

Under the rules, a U.K. company will not be liable to a C.F.C. charge unless it holds a qualifying interest in the C.F.C., which, broadly, is ownership of at least 25% of share capital.

There is an important exemption for finance companies that satisfy certain conditions. This exemption can be full or 75% (the “finance company partial exemption”). Where the finance company partial exemption applies, the finance C.F.C. will suffer an effective U.K. tax rate of 5% when the U.K. corporate income tax rate is 19% (the rate for the 2018-2019 tax year).

However, it should be noted that in October 2017, the European Commission opened a formal investigation into whether provisions of the U.K.’s C.F.C regime, including this exemption, breach E.U. State Aid rules. The outcome of this investigation and the impact of any final decision on the U.K.’s C.F.C rules is currently unknown. If the European Commission decides that the exemption constitutes unlawful State Aid, the U.K. government would be required to recover the benefit of the aid from any groups which have claimed the exemption. The U.K. would be able to appeal the decision, and affected businesses could also intervene.

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

The use of C.F.C. rules as a tax avoidance tool was reviewed by the O.E.C.D. as part of the B.E.P.S. Project. In the 2016 Budget, the U.K. government confirmed that it did not intend to make further changes to the rules as a result of the O.E.C.D.’s recommendations. It considers the current regime to be in line with the O.E.C.D.’s recommendations.

In January 2016, the E.U. Commission published an anti-avoidance tax package that included a draft directive on corporate tax avoidance, known as the Anti-Tax Avoidance Directive (“A.T.A.D.”), which requires all Member States to introduce appropriate C.F.C. rules. On June 20, 2016, the E.U. Council adopted the A.T.A.D. and Member States are expected to comply with the directive by January 1, 2019. There had been concern that in order to comply with the A.T.A.D., the U.K. would need to review the compatibility of its partial company finance exemption. However,

under the final version of the A.T.A.D, no substantive amendments to the U.K.'s C.F.C rules should be necessary. In any event, given that by January 2019, the U.K. will have almost finalized its withdrawal from the E.U., the binding force of the A.T.A.D over the U.K. is questionable.

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

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

A separate regime applies to the attribution of capital gains of foreign companies to U.K. residents if the foreign companies would be considered to be “close companies” had they been U.K. resident, provided a targeted anti-avoidance test is met. Broadly, a company is a close company if it is under the control of five or fewer participants or participants who are also directors.

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

Reflecting the rationale behind the creation of a wide tax exemption for U.K.-resident companies on receipt of dividends (explained in **Dividends Received by U.K. Companies** above), the U.K.'s tax legislation contains a broad exemption from U.K. corporate income tax for the overseas trading profits, gains, and investment income of a branch of most U.K.-resident companies.

The term “branch” is a domestic equivalent of a permanent establishment and the calculation of profits falling within the exemption is determined in accordance with the income tax treaty between the U.K. and the jurisdiction where the permanent establishment is established. If no such treaty exists, the model O.E.C.D. treaty is used. Special and complex rules apply to determine which losses and other reliefs, such as capital allowances, can be claimed if the exemption is not applied.

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

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

Like the C.F.C. rules, the regime contains a number of anti-avoidance rules, and G.A.A.R. provisions will also apply.

## **V.A.T.**

The U.K. charges V.A.T. on the supplies of most goods and services with notable exclusions, such as an exclusion for financial services. Currently, V.A.T. is charged

at 20% (“standard rated”), although some supplies are charged at 0% (“zero rated”) and others at 5% (“reduced rated”). Ultimately, the burden of V.A.T. is intended to be borne by the final consumer. As a general principle of V.A.T. law, a fully “taxable person” should be able to recover all the input V.A.T. incurred in the course of its economic activities. The term “taxable person” is a concept used by the V.A.T. legislation to describe a person who is engaged in economic activities. Conversely, V.A.T. is not recoverable by the “end user,” which is the person who acquires supplies on which V.A.T. has been charged but who is unable to show that the supplies were used by it in connection with its economic activities.

The UK’s V.A.T. system is based on E.U. law and once the U.K. leaves the E.U., U.K. V.A.T. laws will no longer have to comply with the E.U.’s V.A.T. laws.

Given that the U.K. raises around £115 billion a year from V.A.T., it is unlikely to be abolished, although it is unclear whether U.K. V.A.T. will continue to be based on E.U. law. It is expected that the U.K. government will opt to continue the system broadly along current E.U. lines.

However, it is possible that the U.K. government will seek to introduce changes to V.A.T. exemptions and zero-ratings. The U.K. government will also need to assess how supplies to those established in E.U. Member States will be treated, since this could impact V.A.T. recovery for U.K. financial services companies in particular.

It is established law that simply holding shares in a subsidiary in order to receive a dividend does not amount to an economic activity for V.A.T. purposes. Therefore, generally, any V.A.T. incurred on the costs of acquiring and holding shares by a parent company for the sole purpose of holding the shares is not recoverable. For the V.A.T. to be potentially recoverable, the shares must be held for some other “economic” purpose. Consequently, U.K. holding companies seeking to recover V.A.T. should take steps to ensure that they carry on an “economic activity” for V.A.T. purposes. Very broadly, this will involve carrying on a business. If this can be achieved, the V.A.T. costs on share acquisitions or disposals and takeovers may be recoverable.

The V.A.T. treatment of supplies made by holding companies came under scrutiny by the C.J.E.U. in *A.B. v. SKF*<sup>5</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 the V.A.T. incurred on advisors’ fees by the relevant group company, in connection with the takeover of the B.A.A. plc group in 2006, was not recoverable under the particular facts involved. Although the acquiring entity carried on an “economic activity” for V.A.T. purposes, the court found that the fees incurred by it related principally to the acquisition rather than the post-acquisition business of the acquired group.

Both these cases confirm that companies contemplating a share acquisition or disposal should be able to recover V.A.T. incurred on fees if they can show an intention to make taxable supplies. The discussion contained in the *B.A.A.* decision suggests

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<sup>5</sup> *Skatteverket v. AB SKF*, Case C-29/08, [2009] E.C.R. I-10413.

that, possibly, this may be achieved by the acquiring entity showing an intention to supply taxable services to the target upon completion of the takeover. For example, it could supply management services in return for a fee. The intention to make taxable supplies may also be established where the acquirer is grouped for V.A.T. purposes with the target after completion of the takeover and clear evidence exists in the lead-up to the transaction that an intention to group exists. In July 2015, in the joint cases of *Larentia and Minerva*,<sup>6</sup> the C.J.E.U. 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 C.J.E.U. decisions. The consultation closed at the end of February 2017 and a response has not yet been published.

However, in May 2017, H.M.R.C. published updated guidance, confirming that V.A.T. recovery can be made where the holding company is the recipient of the supply if certain conditions are satisfied. The conditions are as follows:

- **The holding company making the claim must be the recipient of the supply.** H.M.R.C. considers this condition satisfied where the holding company has contracted for the supply, including by novation, and it has made use of, been invoiced, and paid for the supply.
- **The holding company must be undertaking economic activity for V.A.T. purposes.** This condition will be satisfied where the holding company makes or intends to make supplies of management services for consideration to its subsidiaries. The management services must be genuine and provided for a consideration that is more than nominal. Full recovery may not be possible if management services are not supplied to all subsidiaries.
- **The economic activity must involve the making of taxable supplies.** The holding company should create and retain contemporaneous evidence of its intention to make taxable supplies. Full recovery may not be possible if in addition to providing management services, the holding company makes exempt supplies in providing loans to the subsidiaries. However, the H.M.R.C. guidance now confirms that where the holding company is lending money to companies within a V.A.T. group and these loans can be seen to support the making of taxable supplies by the V.A.T. group, the related V.A.T. will be recoverable to the extent that the costs support taxable supplies made. This is the case whether the transactions within the group would be taxable or exempt supplies were they not disregarded because of the V.A.T. grouping.

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<sup>6</sup> *Larentia & Minerva v. Finanzamt Nordenahm*, Joined Cases C-108-109/14, [2015] E.C.R. I \_\_\_\_ (delivered on July 16, 2015).

## G.A.A.R. AND FURTHER H.M.R.C. POWERS

### G.A.A.R.

The G.A.A.R. was introduced in the U.K. in July 2013, with the broad intention of counteracting “tax advantages” arising from abusive tax arrangements. This includes obtaining or increasing relief from tax. For the purposes of the G.A.A.R. provisions, a tax arrangement includes agreements, understandings, and transactions to obtain tax relief, whether or not legally enforceable. The G.A.A.R. applies to most U.K. taxes, other than V.A.T.

The following conditions must be satisfied for the G.A.A.R. to apply:

- An arrangement giving rise to a tax advantage is present.
- The tax advantage relates to a tax covered by the G.A.A.R.
- One of the main purposes of the arrangement is to obtain the tax advantage (taking into account all facts and circumstances).
- The arrangement is “abusive.”

Arrangements will be considered to be “abusive” if they cannot reasonably be regarded as a reasonable course of action, having regard to all the circumstances. This is referred to as the “double reasonableness test.”

The circumstances that may be considered when ascertaining whether a transaction is abusive include (i) whether the substantive results of the arrangements are consistent with the underlying policy of the relevant provisions and any principles on which they are based, (ii) whether the means of achieving the tax advantage was contrived or abnormal, and (iii) whether the arrangement exploits any shortcomings in the legislation. The legislation sets out indications of when a transaction is likely to be abusive and includes cases where the tax position does not reflect the economic reality, such as when an interest expense deduction is greater, for tax purposes, than the amount actually paid. Arrangements that are in accordance with established and acknowledged H.M.R.C. practice will generally not violate G.A.A.R. principles.

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

Where the G.A.A.R. applies, H.M.R.C. will be entitled to counteract the tax advantage. To illustrate, it may deny a deduction for interest expense.

There is no clearance procedure enabling taxpayers to obtain confirmation from H.M.R.C. that the G.A.A.R. will not apply to a particular transaction. However, depending on the transaction type and circumstances, other clearances in comparable circumstances will be available over time.

*“H.M.R.C. 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.”*

H.M.R.C. has published Advisory Panel guidance on its interpretation of the G.A.A.R., including examples of where G.A.A.R. will apply. The guidance confirms arrangements reflecting straightforward choices, such as funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, arrangements that are in accordance with long-established practice will not be subject to the G.A.A.R. unless contrived.

### **Disclosure of Tax Avoidance Schemes**

The Disclosure of Tax Avoidance Schemes (“D.O.T.A.S.”) rules were introduced in Finance Act 2004 and broadly require the promoters of certain tax avoidance schemes to disclose details to H.M.R.C. Essentially, the D.O.T.A.S. regime is intended to facilitate H.M.R.C.’s identification of potential tax avoidance schemes at an early stage, with a view to taking action to close down abusive schemes where appropriate.

Following a disclosure under D.O.T.A.S., H.M.R.C. may issue a scheme reference number (“S.R.N.”). Subsequently, taxpayers who choose to use the scheme are required to put the S.R.N. on self-assessment tax returns.

Broadly, the rules apply where (i) there are “arrangements” that are expected to provide a tax advantage, (ii) receiving a tax advantage is expected to be one of the main benefits, and (iii) the scheme falls within one of several descriptions (known as “hallmarks”). Currently, the hallmarks are aimed at new and innovative schemes, marketed schemes, and targeting specific schemes.

### **Accelerated Payment Notices**

Finance Act 2014 introduced new powers for H.M.R.C. to combat tax avoidance by way of Accelerated Payment Notices (“A.P.N.’s”). Since July 2014, H.M.R.C. has been able to demand the payment of disputed tax associated with a tax avoidance scheme upfront, before a tribunal or court has decided whether a scheme is effective. The demand is made in the form of an A.P.N., which can be issued where schemes demonstrate certain “avoidance hallmarks,” such as the scheme being subject to disclosure under the D.O.T.A.S. rules, or the issuance of a counteraction notice under the G.A.A.R. A.P.N.’s can be issued in relation to schemes that were entered into before the A.P.N. legislation came into force.

In brief, once an A.P.N. is issued, a taxpayer has 90 days to pay the tax, unless they successfully make representations to H.M.R.C. that the notice should not have been issued. However, representations can only be made on the grounds that the statutory conditions for the notice to be issued were not fulfilled, for example, that the scheme was not a D.O.T.A.S. scheme (*i.e.*, should not have been notified under the D.O.T.A.S. regime), or that the amount claimed in the A.P.N. is incorrect. There is no right of appeal against an A.P.N. Advance payments will be repaid to the taxpayer with interest in the event that the scheme is ultimately proven to be legitimate.

The introduction of the A.P.N. regime has proved controversial, and the validity of a number of A.P.N.’s has been challenged by judicial review. To date, no judicial review challenge has been successful, and A.P.N.’s remain a powerful tool in H.M.R.C.’s crusade against tax avoidance.

## **Follower Notices**

Alongside A.P.N.'s, Finance Act 2014 introduced the power for H.M.R.C. to issue Follower Notices ("F.N.'s"), which are aimed at marketed tax avoidance schemes where H.M.R.C. has already succeeded in the courts against one scheme user.

H.M.R.C. can issue an F.N. to a taxpayer when a final judicial ruling has been reached in relation to a tax avoidance scheme and H.M.R.C. considers that the principles in the ruling can be applied to deny the tax advantage being claimed by another taxpayer. A final judicial ruling is one that cannot be further appealed.

An F.N. may require the taxpayer to amend its return, if the return is still under examination, or enter into an agreement with H.M.R.C. to settle the dispute, where the taxpayer is appealing a tax assessment. The taxpayer is also required to give H.M.R.C. a notice stating that it has taken the necessary corrective action and notifying H.M.R.C. of the amount of additional tax that has become payable as a result. The taxpayer has 90 days in which to comply.

## **CORPORATE CRIMINAL OFFENSES OF FAILING TO PREVENT TAX EVASION**

### **Background to the Offenses**

In spring 2015, the U.K. government announced its intention to introduce a corporate offense for the failure to prevent tax evasion, 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.

Following two public consultations, two new corporate criminal offences ("C.C.O.'s") were introduced in the Criminal Finances Act 2017 and became law on September 30, 2017.

### **The Offenses**

The legislation creates two new 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 new corporate offenses to apply:

- Criminal tax evasion (and not tax avoidance) must have taken place.
- A person or entity who is associated with the business must have criminally facilitated the tax evasion while performing services for that business.

"Associated persons" are employees, agents, and other persons who perform services for or on behalf of the business, such as contractors, suppliers, agents, and intermediaries.

For either of the offenses to apply, the employee or associated person must have criminally facilitated the tax evasion in its capacity as an employee or associated person providing services to the business. A company cannot be criminally liable for failing to prevent the facilitation of tax evasion if the facilitator was acting in a personal capacity.

### **Reasonable Prevention Procedures**

A company will have a defense against criminal liability if it can prove that it had put in place reasonable 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 will have to undertake a risk assessment to identify the risks of facilitation of tax evasion within the organization and the potential gaps in the existing control environment. The risk assessment should be documented so that it can provide an audit trail to support any policy decisions regarding the implementation of new procedures to reduce the risk of exposure to the C.C.O.'s.

It is expected that following a risk assessment, most companies will have to introduce changes to ensure that they have robust procedures in place to prevent their employees, service providers, agents, suppliers, and customers from engaging in or facilitating tax evasion.

It will be important to secure top level commitment from a company's board and/or senior executives to mitigating the risks of exposure to the C.C.O.'s and the need for the business to respond to such offenses. Companies will also need to ensure that sufficient training on tax evasion and the C.C.O.'s is provided to all staff.

### **Territoriality**

There are two separate offenses which apply where U.K. and non-U.K. tax respectively is evaded.

In relation to U.K. tax, the offense will apply to any company or partnership, wherever it is formed or operates.

Where non-U.K. tax is evaded, a business will have committed an offense if the facilitation involves (i) a U.K. company or partnership, (ii) any company or partnership with a place of business in the U.K., including a branch, or (iii) if any part of the facilitation takes place in the U.K. In addition, the foreign tax evasion and facilitation

*“A business will be held criminally liable if it fails to prevent its employees or any person associated with it from facilitating tax evasion.”*

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 decide not to pay or declare it. Dishonest behavior may involve a person simply deciding not to declare money he or she makes. It may involve someone deliberately trying to hide the source of money, or even intentionally misrepresenting where money came from. In most countries, such dishonest tax evasion is considered illegal and therefore a crime.

Fraudulent tax evasion does not arise where a person makes a mistake or is careless. It also does not arise where a person actively seeks to avoid tax. A person’s attempts to avoid tax may involve using complicated and artificial structures to exploit gaps in the rules of the tax system. Tax avoidance will usually involve arrangements to move assets from one place to another to secure a better tax treatment. Tax authorities may not agree that what has been done is legally effective and may challenge the taxpayer.

However, even if the tax authority successfully challenges a tax avoidance arrangement and the taxpayer is required to pay additional tax, the taxpayer will not have acted dishonestly if he held a reasonable belief that the tax was not due when he entered into the arrangement, even though he may have acknowledged that he may be proven wrong. Tax avoidance would only become evasion if the taxpayer dishonestly withheld or misrepresented information to try to make the planning appear effective when it is not in fact effective.

In relation to the 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. The withholding tax applies to payments made by all persons, even those unrelated to the U.S. account in issue.

In the U.K., concerns were raised by the financial sector about the legal difficulties it would face in complying with F.A.T.C.A. reporting. Particularly, F.I.’s foresaw issues with respect to U.K. data protection laws and a subsequent negative impact on the competitiveness of U.K. financial institutions (“U.K.F.I.’s”) as a result of withholding on U.S.-source payments.

In response, the U.K. government, along with the governments of France, Germany, Italy, and Spain, entered into discussions with the U.S. to address the implementation of F.A.T.C.A. These discussions resulted in the publication of a joint statement on February 8, 2012, which set out an agreement to explore an intergovernmental approach, and the Model Intergovernmental Agreement to Improve Tax Compliance to Implement F.A.T.C.A. on July 26, 2012.

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

### **Implementation of the I.G.A.**

Section 222 of Finance Act 2013 empowers the Treasury to make regulations giving effect to the U.K.-U.S. I.G.A. Accordingly, the International Tax Compliance (United States of America) Regulations 2013,<sup>7</sup> which give effect to the U.K.-U.S. I.G.A., came into force on September 1, 2013. Any expression that is defined in the U.K.-U.S. I.G.A. but not in the F.A.T.C.A. regulations published by the I.R.S. is treated as having the same definition as in the I.G.A.

### **Implications of the I.G.A.**

The U.K.-U.S. I.G.A. has resulted in the following:

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

Therefore, for F.I.’s in the U.K., compliance with the U.S. Internal Revenue Code is intended to be superseded by equivalent obligations under the U.K. I.G.A. and its implementing legislation. The U.K. is responsible for enforcement of these obligations, in the first instance, in place of U.S. withholding. Failure to comply with the U.K. rules will result in the F.I. having to comply with the primary F.A.T.C.A. legislation in order to avoid withholding.

F.A.T.C.A. is particularly complex and its exact application can be uncertain. Most F.I.’s demand information regarding the U.S. or non-U.S. status of all customers or customers having accounts in excess of a certain amount. Where a U.K. holding company may be obliged to comply with F.A.T.C.A. as implemented in the U.K., information on the U.S. status of substantial holders must be provided to the U.K.F.I.

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<sup>7</sup> SI 2013/1962.

# THE COMMON REPORTING STANDARD

## **Background**

*“Tax avoidance will usually involve arrangements to move assets from one place to another to secure a better tax treatment.”*

The Common Reporting Standard (“C.R.S.”) was developed by the O.E.C.D. and provides a mechanism for countries to automatically exchange tax information. Specifically, the C.R.S. allows countries to obtain information from resident F.I.’s and automatically exchange that information with other countries.

The C.R.S. has been incorporated into U.K. law by the International Tax Compliance Regulations 2015. Reporting under the C.R.S. was introduced in 2016, with different countries adopting the regime at different times.

The U.K. is one of 56 jurisdictions that are “early adopters” of the C.R.S., undertaking to adopt reporting requirements from January 1, 2016. U.K.F.I.’s are required to report specified information to H.M.R.C. by May 31, 2017. H.M.R.C. will then exchange the relevant information with participating jurisdictions by September 30, 2017. The remaining countries will implement the C.R.S. in the coming years.

The aim of the C.R.S. is to crack down on the use of offshore jurisdictions to facilitate tax evasion. At this stage, 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. Following the introduction of F.A.T.C.A., the U.K. entered into a similar tax information reporting regime with its Crown Dependencies and Overseas Territories (“C.D.O.T.’s”), known as “U.K. F.A.T.C.A.” U.K. F.A.T.C.A. is being phased out and, ultimately, will be replaced by the C.R.S.

Given that the U.S. has not committed to exchange information under the C.R.S., F.A.T.C.A. arrangements under the U.K.-U.S. I.G.A will remain in place. Ultimately, F.A.T.C.A. and the C.R.S. will run parallel to each other, with F.A.T.C.A. remaining in place for U.S. citizens (including green card holders) and U.S. tax residents, and the C.R.S. applying for many other jurisdictions.

## **Enforcement of the C.R.S.**

Enforcement of the C.R.S. will be implemented by way of a penalty system. Different

jurisdictions may operate different penalty systems for noncompliance.

In the U.K., there are a series of penalties that may apply to noncompliant F.I.'s. There is an automatic penalty of £300 for failing to comply with the C.R.S. and an additional £60 per day penalty if the failure to comply continues after a warning is received from H.M.R.C. There is also an additional flat-rate penalty of £3,000 if H.M.R.C. determines that there are errors on the C.R.S. return itself.

In addition to these specific C.R.S.-related penalties, H.M.R.C. may also levy tax-related penalties under the existing tax penalty regimes. There is a specific penalty regime for offshore tax evasion, which was recently strengthened.

U.K. taxpayers who may be liable to tax-related penalties under the C.R.S. should be aware that the percentage penalty can be increased, depending on the territory and the severity of the offence, to up to twice the original tax cost if there is an offshore element involved.



## BELGIUM

**Author**  
Werner Heyvaert  
*De Langhe Attorneys*  
Brussels, Belgium

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

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

### CORPORATION INCOME TAX

#### **General Regime**

A Belgian company is subject to corporation income tax on its worldwide profit. For corporation income tax purposes, a company’s taxable profit is determined based on its commercial accounts prepared as standalone Belgian G.A.A.P. accounts. Statutory accounts prepared using I.A.S. or I.F.R.S. cannot be utilized for Belgian corporate tax purposes.

Following a major overhaul of Belgium’s corporation income tax (“C.I.T.”) in December 2017, the C.I.T. rate is 29.58% (29% plus a 2% surcharge). In 2020, the C.I.T. rate will be reduced to 25%. Note that under certain conditions, small- and medium-sized enterprises (“S.M.E.’s”) may benefit from a reduced rate of 20.4% (lowered to 20% in 2020).

Belgium recently introduced a minimum taxable base for companies with taxable profits that exceed €1 million by imposing limitations on certain deductions (e.g., tax loss carryforward, dividends received deduction carryforward, etc.). These items will only be deductible for up to 70% of the taxable profits in excess of €1 million.

Consequently, companies will need to re-assess their use of these tax attributes and their recognition of related deferred tax assets.

#### **Participation Exemption for Dividends Received**

Under the participation exemption, qualifying dividends received by a Belgian

<sup>1</sup> Royal Decree of May 23, 2007.

The author would like to acknowledge the contributions of Mr. Hans Declair, independent tax counsel, and Kim Bronselaer, Evert Moonen, and Justine Bouckaert, also of De Langhe Attorneys, in the preparation of this section.

company are eligible for a 100% exemption from C.I.T. (up from 95% through December 31, 2017).

### *In General*

As of assessment year 2019 (*i.e.*, accounting years ending on or after December 31, 2018), dividends received will be fully exempt from C.I.T. if the participation meets the following cumulative conditions:

- The corporate recipient of the dividend owns at least 10% of the subsidiary making the payment or the acquisition value of its holdings in the subsidiary is at least €2.5 million.
- The corporate recipient has held, or has committed to hold, its participation interests in full for at least 12 months.
- The subsidiary making the dividend payment is subject to a comparable tax.

These conditions are discussed in greater detail, below.

### *Dividends Received in a Year Having Operating Losses*

Prior to assessment year 2019, the participation exemption provided a benefit if the company receiving the dividend reported positive income other than dividends. In principle, the remaining 5% of dividends received were part of the taxable income of the Belgian holding company. If the Belgian company's other activities resulted in a loss in the current year, the loss was used to offset dividend income. As a result, the benefit of the loss carryover was reduced or completely eliminated. Moreover, the unused portion of the dividends received deduction was permanently lost.

This position was challenged in an appeal to the European Court of Justice ("E.C.J.") and in *Cobelfret v. Belgium* (Case C-138/07). 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. Parent-Subsidiary Directive ("P.S.D."). Two other cases were decided by "reasoned order" of the E.C.J. on June 4, 2009.<sup>2</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 dividends received deduction can be carried forward for use in future tax years only if, at the time that the dividend is declared, the dividend-distributing company is established

- in a Member State of the European Economic Area ("E.E.A."), including Belgium, although for dividends declared before 1994, non-E.U. Member States of the E.E.A. are not taken into consideration, as the E.E.A. entered into effect on January 1, 1994;
- in a country with which Belgium has concluded a bilateral tax treaty that contains an equal treatment clause (functional equivalent of Article 22(1)(c) of the Belgium-U.S. Income Tax Treaty currently in effect); or

<sup>2</sup> *Belgische Staat v. KBC Bank NV*, Joined Cases C-439/07 & C-499/07, [2009] E.C.R. I-04409.

***“Under the participation exemption, qualifying dividends received by a Belgian company are eligible for a 100% exemption from C.I.T.”***

- in another country, provided that Article 56 of the Treaty of Rome applies (free movement of capital – Article 63 of the Treaty on the Functioning of the European Union, or “T.F.E.U.”) to the (share) capital represented by the shares that produce the dividends.

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

Where the facts of a particular case involving dividends from a company meet none of the foregoing criteria, the law remains unfavorable for taxpayers. According to a ruling of February 1, 2011 from the Tribunal of First Instance in Brussels, the rule that excess dividends cannot be carried over if they stem from subsidiaries in non-E.E.A. countries (with which Belgium does not have a bilateral tax treaty in force containing an equal treatment provision) does not run afoul of the Belgian constitutional non-discrimination rule.

In the facts addressed by the Brussels Tribunal, the tax administration allowed a taxpayer to carry over excess dividends from a Japanese subsidiary of a Belgian holding company because there is an equal treatment provision in Article 23(2)(a) of the Belgian-Japanese bilateral tax treaty. However, the tax administration refused to allow the carryover of Taiwanese and South Korean dividends, because the treaties with those jurisdictions did not contain an equal treatment clause. Before the Brussels Tribunal, the taxpayer claimed that the aforementioned distinction ran afoul of the Belgian nondiscrimination rule of 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 double tax treaties with equal treatment clauses does not constitute a violation of the constitutional nondiscrimination principle.

#### Minimum Participation Value

Dividends distributed by a subsidiary are eligible for the participation exemption if the corporate recipient owns at least 10% of the nominal share capital of the subsidiary, or the acquisition price for, or value of, the holding in the subsidiary is at least €2.5 million.

#### Minimum Holding Period

A minimum holding period of one uninterrupted year is required in order for the dividends received deduction to apply. The minimum holding period of one uninterrupted year may occur partly before and partly after the dividend distribution. Moreover,

the Belgian holding company is required to have full legal title to the shares. A right of *usufruct*<sup>3</sup> over the shares does not suffice.

In general, the minimum holding period should cover shares representing the minimum percentage or the minimum price or value required to enjoy the participation benefit. This means that dividends stemming from shares acquired less than one year before the dividend distribution of the dividend should qualify for the dividends received deduction provided the Belgian holding company has held on to 10% or €2.5 million worth of shares for one uninterrupted year, as defined.

### Subject to Comparable Tax

To qualify for the participation exemption for dividends received, the subsidiary paying the dividend must meet a subject-to-tax requirement. If the subject-to-tax requirement is not met, the dividends are not exempt in the hands of the corporate shareholder. Consequently, the dividends received deduction is not available for dividends distributed by a company that is subject to neither Belgian corporation income tax nor to a foreign tax similar to the Belgian corporation income tax. A foreign tax is not considered similar if it is substantially more advantageous than Belgian corporation income tax. Typically, this means that the nominal rate of tax or the effective rate is below 15%. It is uncertain how this rule will be interpreted in light of the reduced Belgian C.I.T. tax rates effective for 2018 and later.

The Royal Decree implementing the Belgian Income Tax Code contains a list of jurisdictions that fail the normal-tax-regime test. As of June 1, 2016, this list includes the following jurisdictions:

Abu Dhabi	Ajman	Andorra	Bosnia & Herzegovina
Dubai	East Timor	Gibraltar	Guernsey
Isle of Man	Jersey	Kosovo	Kuwait
Kyrgyzstan	Liechtenstein	Macau	Macedonia
Maldives	Marshall Islands	Micronesia	Monaco
Montenegro	Oman	Paraguay	Qatar
Ras al Khaimah	Serbia <sup>4</sup>	Sharjah	Turkmenistan
Umm al Qaiwain	Uzbekistan		

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

The tax regimes of all E.U. jurisdictions are deemed to be equivalent to the Belgian corporation income tax regime, even if the tax rate would be below 15%. Examples of countries benefiting from this rule are Ireland and Cyprus.

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<sup>3</sup> 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>4</sup> Note that due to an increase of the corporate tax rate in Serbia to 15%, dividends may qualify for the participation exemption. See ruling no. 2016.740 of November 29, 2016.

## **Exceptions to Participation Exemption**

### **Proscribed Business Activities**

The participation exemption for dividends received is not available for dividends distributed by a company defined as a finance company, a treasury company, or an investment company where the entity enjoys a tax regime that deviates from the normal tax regime in its country of residence.

A finance company is a company for which providing financial services (e.g., financing and financial management) to unrelated parties (i.e., parties that do not form part of a group to which the finance company belongs) is its sole or principal activity. For these purposes, a group is defined under the standard previously applicable to the Belgian Coordination Center Regime. It includes affiliated companies under a unique management due to direct or indirect participation of members. A group is presumed to exist when a company maintains a 20% shareholding in another company or owns 20% of voting rights in another company.

A treasury company is defined as a company mainly or solely engaged in portfolio investment other than cash pooling. An “investment company” is defined as a company whose purpose is the collective investment of capital funds (e.g., S.I.C.A.V.’s, S.I.C.A.F.’s, and comparable entities).

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

### **Regulated Real Estate Company**

The participation exemption for dividends received is not available for dividends derived from a Belgian regulated real estate company. It also applies to a nonresident company under the following conditions:

- 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 Activity**

The participation exemption for dividends received is not available for dividends distributed by a company when the non-dividend income of that company originates in a third country and such income is subject to a separate tax regime that provides more favorable results than the normal tax regime.

### **Certain Foreign Branch Income**

The participation exemption for dividends received is not available when the dividends are distributed by a company that realizes profits through a foreign branch that is subject to a tax assessment regime substantially more advantageous than the tax that would apply to such profits had the operations been conducted in Belgium. This disallowance rule is subject to an exception. The dividends received



deduction will be allowed for dividends distributed by Belgian companies with foreign branches or companies established in certain treaty jurisdictions that operate through a branch in a third country.

Dividends stemming from non-Belgian branch profits qualify for the dividends received deduction to the extent that either the branch profits are subject to a 15% foreign income tax or the branch is located in another E.U. jurisdiction.

### Intermediate Companies

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

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

With respect to investments in or through hybrid entities such as U.S. limited liability companies (“L.L.C.’s”), the Belgian Ruling Committee issued several favorable rulings. In most instances, the Ruling Committee confirmed that, for Belgian tax purposes, one can look through a foreign hybrid entity to allow the participation exemption as if the underlying participations had been held directly by the Belgian holding company.

### Dividend Payments that are Deductible for the Payor

The participation exemption for dividends received is not applicable to dividend income received from a company that has deducted or can deduct such income from its profits.

### Anti-Abuse Rule

The participation exemption for dividends received is not available to a company that distributes income related to a legal act or a series of legal acts that the Belgian tax administration has determined, taking into account all relevant facts, circumstances, and proof to the contrary, are not genuine and have as its main goal or one of its main goals the attainment of the deduction or one of the benefits of the P.S.D. in another E.U. Member State. Actions will be considered “not genuine” if they are not taken for valid commercial reasons that reflect economic reality.

### Purchased Dividend

The term “purchased dividend” is used to describe the following fact pattern. At the time a target company (“Target”) is being acquired by an acquiring company (“Acquirer”), it has substantial earnings and profits on its balance sheet, and the Acquirer

*“For tax years 2018 and 2019, capital gains on shares are exempt provided that the participation, holding period, and subject-to-tax requirements are each met.”*

pays “dollar for dollar” for such earnings and profits. Shortly after completion of the acquisition, the Acquirer has the Target distribute substantially all of the pre-acquisition earnings and profits in the form of a dividend. Typically, the Acquirer will utilize the proceeds of the dividend distribution to repay a portion of the acquisition debt.

According to the Belgian Commission for Accounting Standards (“C.A.S.”), purchased dividends should not go through the Acquirer’s profit and loss account, but should reduce the book value of the Target-shareholding in the balance sheet of the Acquirer.<sup>5</sup> For this purpose, book value should equal the purchase price. As a result, the purchased dividend is not included in the Acquirer’s financial income. Consequently, it does not need to invoke the dividends received deduction. The Acquirer is not subject to tax on the nondeductible portion of 5% of the purchased dividend.

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

### Ruling Practice

The Belgian tax administration must, upon a taxpayer’s request, issue an advance tax ruling on items such as the availability of the dividends received deduction (*i.e.*, exemption) and (indirectly) the capital gains exemption, whether any anti-abuse provisions apply in a particular case, and whether a company qualifies as a Belgian resident or nonresident taxpayer. No such ruling will be granted, however, with respect to jurisdictions or types of companies listed as nonqualifying in the official tax haven list (see **Subject to Comparable Tax** above),<sup>6</sup> although the taxpayer is entitled to rebut the presumption following from this list. In principle, the tax authorities must issue their ruling within three months of the receipt of a complete and exhaustive ruling application.

As previously mentioned, the law of December 1, 2016 introduced a specific anti-abuse provision applicable to the dividends received deduction, the capital gains exemption, and the withholding tax exemption for parent companies, in addition to Belgium’s general anti-abuse provision, taxpayers must give appropriate attention to the business motives of a holding structure when considering applying for a ruling.

### Capital Gains Exemption

Gains realized by a holding company on the alienation of shares are fully exempt from C.I.T. if the potential income would be exempt under the dividend participation exemption, provided that the shares have been held in full for at least 12 months.

<sup>5</sup> Advice No. 151/2 of March 1995.

<sup>6</sup> Note that should the corporate income tax in the relevant jurisdiction increase to 15%, a ruling may nevertheless be possible. See, *e.g.*, ruling no. 2016.740 of November 29, 2016.

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.). A specific anti-abuse provision prohibits the exemption for capital gains on shares that follow a temporarily tax-exempt exchange of shares during which the subject-to-tax requirement was not fulfilled.

The minimum participation requirement does not apply to insurance and reinsurance companies that hold participations to hedge their liabilities.

For tax years 2018 and 2019, capital gains on shares are exempt provided that the participation, holding period, and subject-to-tax requirements are each met. Capital gains are taxed at a rate of 25.5% if the one-year holding period requirement is not met, and at a rate of 29.58% if the participation or taxation requirements are not met. From tax year 2020 onwards, capital gains on shares will continue to be exempt if all conditions are met, but will be taxed at the standard rate (25%) if they are not.<sup>7</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 dividend received deduction has important consequences in the following cases:

- **The “One taints all” principle.** Prior to assessment year 2019, according to the Belgian Revenue Service, capital gains on the disposal of a share package containing a tainted share (*i.e.*, a share that did not qualify for the dividend received deduction) were not exempt. After the reform, it is clear that a proportional exemption is possible (similar to the rules for the dividend received deduction).
- **Disposals of part of a qualifying participation.** Assume that a taxpayer has a qualifying participation (more than 10% or €2.5 million) and that it only disposes of a part (less than 10%) of that participation. Although this is not explicitly mentioned in the law, legal doctrine agrees that the capital gain exemption should apply.
- **Exchanges of shares.** Subject to certain conditions, when a Belgian company contributes shares in a Belgian or European company in exchange for new shares of the same company, this capital gain is (temporarily) exempt under the Merger Directive. As a result, it is possible to exchange tainted shares for untainted shares and then request the exemption for capital gains on shares as described above. The Belgian legislature has therefore implemented an anti-abuse provision limiting the exemption to the capital gains that accrue after the exchange of shares. Please note that this provision only applies to shares that do not meet the valuation requirement. Why the holding and/or participation requirements are not also subject to this provision is unclear and may lead to its improper use.

If the exemption applies, only the net amount of eligible capital gains is exempt from tax. Consequently, costs and expenses incurred by the corporate shareholder in connection to the realization of the exempt gain must be allocated to that gain. As a result, these expenses do not reduce ordinarily taxed income and no benefit is received.

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<sup>7</sup> Law of December 25, 2017, implemented in Articles 192 ¶¶1(1), 216 (2), and (3) I.T.C.

### 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.

In the past, uncertainty existed regarding the participation exemption where the shares were acquired by the Belgian holding company at a price or value that was far below the actual value at the time of acquisition. The position of the Belgian tax authorities was that the difference between the low acquisition value and the high actual value should be booked as an undervaluation of assets and taxed as regular income of the holding company. The income accrued in the year of acquisition and should be taxed retroactively at the full corporation income tax rate of 29.58%.

This position was successfully challenged in the *Gimle* case in a preliminary ruling from the E.C.J. that was settled definitively by the Court of Cassation.<sup>8</sup> Going forward, the full gain based on the low purchase price is exempt.

The capital gains exemption is granted by a direct elimination of the net gain from taxable income. Consequently, loss utilization is not adversely affected. Losses derived from other activities of the Belgian holding company are not allocated to the exempt gain.

The minimum participation requirement does not apply to insurance and reinsurance companies that hold participations to hedge their liabilities.<sup>9</sup>

Any holding company that meets the participation and subject-to-tax requirements but does not meet the one-year holding requirement is subject to tax on gains realized on the alienation of those shares at a rate of 25.5% (to reduce to 25% in 2020) or 20.4% (if applicable).

### 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 are met. The exemption does not apply to gains derived from the sale of the option or the warrant. If the call option itself were sold at a gain, the gain would be subject to the regular corporation income tax rate.

### Unrealized Gains

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, said unrealized gain is not taxable if it is booked in a non-distributable reserve account. Upon later realization of the gain, the non-distributable reserve account disappears without triggering corporation income tax, assuming all conditions for the participation exemption for capital gains are met at that time.



<sup>8</sup> Court of Cassation, May 16, 2014, F.10.0092.F.

<sup>9</sup> Article 192, ¶1(1) I.T.C.

### Capital Losses

Capital losses on shares (realized or non-realized) are not tax deductible. However, the loss incurred in connection to the liquidation of a subsidiary company remains deductible up to the amount of paid-up share capital.

### Expenses on Sales

Pursuant to the Law of June 22, 2005, only the net amount of capital gains is exempt, *i.e.*, the gross capital gains minus costs and expenses incurred in connection to the realization of the gain (*e.g.*, brokerage fees, stamp duties, etc.). In a circular letter of April 6, 2006, the Belgian tax authorities commented on the limitation of the exempt amount of the capital gains on shares. This circular letter contains, *inter alia*, a list of costs and expenses that must be deducted from the gross amount of the sales proceeds of the shares in order to compute the net amount of the capital gains that is eligible for exemption from corporation income tax. These include the following:

- Costs of publicity (*e.g.*, advertisements, etc.)
- Fees of a civil law notary
- Brokerage fees
- Financial costs (*i.e.*, foreign exchange losses)
- Financial discounts
- Stamp taxes
- Export levies
- Insurance or other coverage costs
- Commission fees
- Advisory fees
- Consultancy costs
- Transportation costs
- Technical audit and inspection costs, which may include costs for vendor due diligence
- Fees of experts, appraisers, etc.

The rationale behind this rule is to curtail the use of a double dip. The gross amount of the sales proceeds of the shares was used to determine the exempt capital gains on shares while all costs and expenses incurred with the sale of the shares were deductible against ordinary income.

### Liquidation and Redemption Proceeds

The participation exemption applies to payments received in connection to a liquidation or redemption of shares.

*“As a general rule, all dividends distributed by Belgian companies to resident and nonresident shareholders are subject to a withholding tax of 30%.”*

Note, however, that the law of December 1, 2016 introduced specific anti-abuse provisions applicable to the participation exemption for dividends received, the capital gains exemption, and the withholding tax 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, taxpayers must have appropriate business motives for the implementation of a holding structure, as previously discussed.

## WITHHOLDING TAX ON DISTRIBUTIONS

### To Belgium

Dividends distributed by a non-Belgian company to a Belgian company may be subject to a dividend withholding tax at the rate in effect in the country of residence of the company paying the dividend. In most situations, this rate is reduced or eliminated by a bilateral tax treaty or the P.S.D. With the exception of investment companies, Belgium does not grant a tax credit for foreign withholding tax imposed on dividends.

### From Belgium

As a general rule, all dividends distributed by Belgian companies to resident and nonresident shareholders are subject to a withholding tax of 30%. Under specific circumstances, reduced rates or exemptions are available.

A full exemption of Belgian withholding tax applies on the distribution of dividends to a parent company established within the E.U. (including Belgium) or in a country with which Belgium has concluded a bilateral income tax treaty containing an exchange of information provision. In the latter instance, the shareholder must hold at least 10% of the capital of the Belgian-resident company.<sup>10</sup> Once a qualifying parent company holds a qualifying participation, all additional acquired shares also qualify, even if the one-year holding period is not met with respect to the additional shares.

### Denkavit, Tate & Lyle, and Less-Than-10% Investments

Following the ruling from the E.C.J. in the *Denkavit* case, Belgium abandoned the condition that the parent must have held a participation of at least 10% for an uninterrupted period of at least one year preceding the distribution of the dividend. Therefore, the parent may hold the 10% participation for one entire year, which may occur partly before and partly after the dividend distribution. If the one-year hurdle is not fully met at the time the dividend is paid, the Belgian distributing company is allowed to pay out the net dividend only (*i.e.*, the gross dividend minus an amount equal to the dividend withholding tax that would apply if the one-year holding period is not respected, thereby taking into account any treaty-based reductions that would be available if the one-year holding period is not met). If the latter occurs, the amount of withholding tax becomes due, increased by interest for late payment. Otherwise, the undistributed portion of the dividend can be distributed freely once

<sup>10</sup> The Belgian tax authorities take the view that the agreement between Belgium and Taiwan does not qualify as a bilateral tax treaty. Therefore, the reduction of dividend withholding tax to 0% for dividends distributed by a Belgian company will not be available to the extent such dividends are distributed to a Taiwanese parent company.

*“Effective as of tax assessment year 2019, the N.I.D. will be applicable only to the increase in qualifying equity rather than the amount of the qualifying equity of the previous tax year.”*

the one-year holding requirement is met.

Unlike the participation exemption, the exemption from dividend withholding tax is subject to the conditions mentioned in the P.S.D. with respect to the legal form, E.U. tax residence, and the parent company’s compliance with a subject-to-tax requirement. As a result of the amendment of the P.S.D., several types of entities that were not eligible for the withholding tax exemption now qualify, most notably the “European company” or *societas europaea* (“S.E.”). The legal form requirement does not apply to dividends paid to Belgian entities provided they are subject to Belgian corporation income tax.

The Corporate Tax Reform Law of December 25, 2017 repealed the “Tate & Lyle” withholding tax rate of 1.6995% on dividends that had been introduced at the end of 2015 in order to make Belgian law compliant with the E.C.J.’s *Tate & Lyle* ruling (Case C-384/11). Due to the changes to the dividends received deduction regime (see **Participation Exemption for Dividends Received** above), 100% of qualifying dividends are now deductible instead of the 95% exemption that was in place prior to 2018). The special withholding tax rate of 1.6995% was no longer necessary and was, thus, repealed.

Additionally, there was another problem that Belgian lawmakers wanted to mitigate. Corporate investors established in other E.E.A. Member States would be subject to double taxation if they held a participation in a Belgian corporation 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 dividends received deduction, which is 100% as of January 1, 2018, and be allowed a full credit and refund for Belgian dividend withholding tax withheld at the source. However, prior to January 1, 2018, the €2.5 million threshold did not apply for the exemption from dividend withholding tax, 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 withholding tax on any dividends received from its Belgian participation.

To remedy this unequal treatment, the Law of December 25, 2017 introduced a new dividend withholding tax exemption. The 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 withholding tax 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 withholding tax against its mainstream tax liability and receive a full refund of any excess withholding 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 corporate income tax regime in the other Member State.

### **Liquidation/Redemption Distributions to Persons Not Entitled to the Participation Exemption**

Until September 2014, the dividend withholding tax rate was 10% in the case of the liquidation of a Belgian company. This reduced rate has been abandoned, effective

October 1, 2014. A transitional regime encouraged companies to strengthen their capital by converting their reserves into capital before or during the accounting year ending at the latest on September 30, 2014, at a rate of 10%. By doing so, the 30% withholding tax, due upon liquidation, could be limited to the 10% withholding tax, due upon conversion.

The transitional 10% withholding tax regime for liquidation distributions has become permanent for S.M.E.'s. As of tax year 2015, S.M.E.'s are allowed to allocate part or all of their accounting profit to a liquidation reserve. The reserve must be booked in an unavailable equity account that is subject to a separate 10% tax. No additional withholding tax will be due provided that this reserve is maintained until liquidation and hence distributed as a liquidation distribution.

Distributions to shareholders made pursuant to a resolution by the company to redeem or buy back its own stock from shareholders have been subject to a preferential withholding tax regime for many years. However, the preferential regime was abandoned, effective January 1, 2013. The withholding tax rate is now set at 30% if dividends result from a redemption of shares or a share buy-back.

Distributions pursuant to liquidations and redemptions may be eligible for rate reductions or exemptions from withholding tax under a bilateral income tax treaty concluded by Belgium, the P.S.D., or the unilateral extension of the P.S.D. withholding tax exemption discussed above.

Through December 2017, any repayment of share capital or share premium to the shareholders was exempt from dividend withholding tax, provided that the reimbursed capital consists of paid-up fiscal capital, does not consist of reserves, and the reduction of capital is executed in accordance with the Belgian Company Code.

In order to combat certain abusive “step-up” structures, the Law of December 25, 2017 introduced a relatively complex set of rules governing the reduction and reimbursement to shareholders of “fiscal share capital.”<sup>11</sup> From January 1, 2018 onwards, any reduction of share capital (including qualifying share premium) will be deemed to stem 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 stem from fiscal share capital and premium will no dividend withholding tax 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, *i.e.*, a 30% withholding tax, unless any other reduction or exemption is available (*e.g.*, on the basis of a bilateral tax treaty).

### **Refund of Withholding Tax for Nonresident Investment Funds**

Following the E.C.J. ruling of October 25, 2012 (Case No. C-378/11), the Belgian tax authorities issued a circular letter<sup>12</sup> regarding the conditions and formalities for non-resident investment funds to obtain a refund of Belgian withholding tax imposed on

<sup>11</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>12</sup> Ci.R.H. 233/623.711, AAFisc No. 11/2013, dated March 4, 2013 and the addendum dated June 13, 2013.

*“The Constitutional Court stopped short of ordering the Belgian state to reimburse all amounts of Fairness Tax it had collected. However, under certain circumstances, taxpayers may still be entitled to claim reimbursement.”*

dividends. The circular letter limits requests for refunds from prior years to dividends paid or attributed between June 12, 2003 and December 31, 2012 to investments funds covered by E.U. Directive 85/611/E.E.C. of December 20, 1985, or Directive 2009/65/E.C. These directives were adopted into Belgian law as part of the Law of August 3, 2012. Only the amount of withholding tax that cannot effectively be credited or reimbursed to the investment fund in its state of residence is eligible for a refund in Belgium.

Foreign investment funds have a five-year period to claim the refund after the Belgian withholding tax was initially paid.<sup>13</sup> The circular letter does not mention whether interest will be allowed, but authoritative legal doctrine and case law from the Constitutional Court support the view that the refund of withholding tax is eligible for interest payment.

### **Fairness Tax**

Effective as of the book year ending on or after December 31, 2013, Belgian companies making profit distributions have had to take into account the Fairness Tax.<sup>14</sup> Belgian companies and Belgian branches of foreign companies making profit distributions out of income that had not, effectively, been subject to corporation income tax might have been subject to a standalone tax of 5.15% (5% plus an austerity surcharge of 3%) under certain conditions. The Fairness Tax was not a withholding tax, but a tax on the distributing company in many respects akin to the Alternative Minimum Tax in the U.S. The Fairness Tax was imposed when corporation income tax was eliminated by the N.I.D. or carryover losses, but the company paid a dividend nonetheless.

The legal validity of the Fairness Tax and its compliance with E.U. law had been open to question since its inception. A request to annul the Fairness Tax was filed with the Belgian Constitutional Court in 2015.<sup>15</sup> The Belgian Constitutional Court requested a preliminary ruling from the E.C.J. on the compatibility of the Fairness Tax with E.U. law.

On May 17, 2017, the E.C.J. – following the Advocate General’s opinion – found that the Fairness Tax did not violate the freedom of establishment and was not a prohibited withholding tax under the P.S.D. However, the E.C.J. did find that the Fairness Tax partially violated the P.S.D., since 5% of received dividends were taxed in the year of receipt – pursuant to the dividends received deduction as it stood through December 31, 2017 – and such dividends were additionally subject to the Fairness Tax in the year of redistribution. According to the E.C.J., the Belgian Constitutional Court had to assess whether a Belgian permanent establishment was treated less favorably than a Belgian corporation when calculating the taxable base subject to the Fairness Tax. To the extent such discrimination did exist, the Fairness Tax would also violate the E.U. principle of freedom of establishment.

The Belgian Constitutional Court handed down its ruling on March 1, 2018. In essence, the court ruled that the Fairness Tax was unconstitutional but would maintain its effect for past years. In other words, the Constitutional Court stopped short of

<sup>13</sup> See the ruling of the Court of First Instance dated April 3, 2017.

<sup>14</sup> Inserted in the I.T.C. by the Law of July 30, 2013.

<sup>15</sup> Constitutional Court case no. 11/2015 dated January 28, 2015 (No. 5828).

ordering the Belgian state to reimburse all amounts of Fairness Tax it had collected from taxpayers since the its introduction at the end of 2015. However, under certain circumstances, taxpayers may still be entitled to claim reimbursement for Fairness Tax unduly paid prior to March 1, 2018.

In the meantime, Belgium's government made the political decision to repeal the Fairness Tax altogether for future years. As of June 2018, the bill of law repealing the Fairness Tax is awaiting publication in the Belgian State Gazette.

## TAX TREATMENT OF BORROWING AND INTEREST PAYMENT

### **Deductible Interest in General**

In principle, interest expense incurred by a Belgian company is tax deductible. However, limitations apply to the deduction.

Belgium has a thin capitalization rule (Article 198, 11°, I.T.C.) providing for a 5:1 debt-to-equity ratio. The ratio applies to test the deduction for interest paid to low-tax and tax haven lenders and to companies of the same group. Because the government did not want this new thin capitalization rule to apply immediately to Belgian treasury centers, qualifying treasury centers are allowed to offset interest owed to group companies against interest received from group companies. Only the excess amount of net interest owed to group companies is disallowed if the 5:1 debt-equity ratio is exceeded.

### **A.T.A.D. Limitations**

Belgium has implemented the Anti-Tax Avoidance Directives ("A.T.A.D. 1" and "A.T.A.D. 2") adopted by the European Commission. A limitation on deductible interest will apply for the greater of €3 million or 30% of E.B.I.T.D.A., computed in accordance with specific rules laid down in the Belgian I.T.C.

The new limitation will only apply to interest on loans concluded or substantially amended after June 17, 2016. The existing thin capitalization rule ratio (5:1) will continue to apply to interest on intra-group loans and interest paid to "tax havens."

For the calculation of interest and E.B.I.T.D.A., an *ad hoc* consolidation will be made.

Nondeductible interest will be eligible to be carried forward indefinitely. It will be possible to transfer nondeductible interest to other companies in the same group pursuant to a "group contribution regime" from 2020 onwards.

Standalone entities and financial companies will be excluded.

### **Interest on Debt Pushdowns Payable at Redemption**

Interest must be related to the conduct of a business in order to be deductible. That is not clearly the case when the underlying debt is incurred to acquire a qualifying participation in another company, 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. The facts of the case are as follows:

- On July 1, 2012, a Belgian company (“BelCo”) borrowed €450 million from its parent company, another Belgian company (“Parent”), at arm’s length interest rate.
- €350 million of this borrowed money was utilized by BelCo to reimburse share capital to its shareholders (including Parent), and €100 million was utilized to pay an intermediary dividend to its shareholders (including Parent).
- The capital reduction and the intermediary 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 as 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., *i.e.*, that a cost or expense must be borne to produce or maintain taxable income.



The Court of Appeals agreed 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, and is not in the case at issue, a cost or expense that was incurred to produce or maintain taxable income for BelCo. As of June 2018, BelCo has filed an appeal against this ruling with the Court of Cassation, the highest Belgian court in tax matters.

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. Since Parent was the majority shareholder of BelCo, the capital reduction and dividend distribution by BelCo to Parent replaced almost all of the loan amount. 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 ruling was silent on the matter, it is likely that the interest paid to Parent was not effectively taxable because it either had carried-forward tax losses or incurred tax-deductible interest expenses of its own.

### **Notional Interest Deduction**

Pursuant to the law of June 23, 2005 and effective January 1, 2006, Belgian corporations are entitled to a notional interest deduction (“N.I.D.”). The N.I.D. is a tax deduction for hypothetical interest owed on the corporation’s equity as it appears in its commercial balance sheet. The notional interest rate is restated every year. For fiscal year 2019 (financial book years ending on or after December 31, 2018), the N.I.D. rate is equal to 0.746% (1.246% 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.<sup>16</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, *inter*

<sup>16</sup> Law of December 13, 2012 on Tax and Financial Provisions (*Belgian State Gazette*, December 20, 2012, 4th Edition). Transitional provisions are available regarding the right to utilize any existing “inventory” of carried over N.I.D. going forward.

*alia*, the commercial book value of participations that qualify for the participation exemption.<sup>17</sup>

Following the Belgian Corporate Income Tax Reform Law of December 25, 2017, the N.I.D. regime has been substantially amended.<sup>18</sup> Effective as of tax assessment year 2019, the N.I.D. will be applicable only to the increase in qualifying equity rather than the 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 it was 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. is negligible. As discussed above, the N.I.D. rate for tax assessment year 2019 is 0.746% for regular companies and 1.246% for S.M.E.’s.

In addition, Belgium’s patent income deduction (“P.I.D.”) was abolished as of July 1, 2016, subject to grandfathering according to which the P.I.D. may still be applied until June 30, 2021 for qualifying patents received or applications filed before July 1, 2016. A new innovation income deduction (“I.I.D.”) has been introduced, based on the “modified nexus approach” recommended by the O.E.C.D. in B.E.P.S. Action 5. The new regime is effective as of July 1, 2016. Under the I.I.D. regime, qualifying intellectual property income is eligible for a tax deduction of up to 85%, resulting in an effective tax rate of 5.10% (*i.e.*, the regular rate<sup>19</sup> of 25.58% applied to the remaining 15%). One of the benefits of the I.I.D. over the phased-out P.I.D. regime is that income from copyrighted software is also eligible for the 85% deduction.<sup>20</sup> Through June 30, 2021, the former P.I.D. regime and the new I.I.D. regime can be applied simultaneously.

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<sup>17</sup> The initial rule that excluded the net assets of a Belgian corporation held through a branch (“permanent establishment”) located in a treaty country and real estate located in a treaty country from the basis for computation of the N.I.D. was repealed following the *Argenta Spaarbank* case of the E.C.J. (Case No. C-350/11 of July 4, 2013). The Belgian statute was amended on December 21, 2013 and the Belgian tax authorities commented on the new rules in a circular letter dated May 16, 2014. Note that the Belgian tax authorities and the Belgian courts have a different opinion regarding the application of the new rules. The tax authorities have applied the amended N.I.D. calculation method for all past years. The courts do not agree with this approach and state that the new rules should be applied from tax assessment year 2014 onwards.

<sup>18</sup> Article 49 of the Law of December 25, 2017 on Corporate Income Tax Reform, *Belgian State Gazette*, December 29, 2017.

<sup>19</sup> The Law of December 25, 2017 on Corporate Income Tax Reform reduced the standard corporate income tax rate to 29% for all companies from 2018 onwards, and to 20% on the first tranche of taxable income for S.M.E.’s (*i.e.*, the first €100,000). The austerity tax of 3% applicable to the aforementioned rates will be phased out. For 2018 and 2019, the austerity tax will be maintained but the rate will drop to 2% ( $29 \times 2\% = 0.58\%$  – hence the aggregate regular rate of 29.58%, and  $20 \times 2\% = 0.4\%$  – hence the aggregate rate of 20.40% for S.M.E.’s). From 2020 onwards, the headline rate will reduce to 25% (20% for the first tranche of taxable income for S.M.E.’s) and no additional austerity tax will apply.

<sup>20</sup> For further details, see: Heyvaert, Werner. “Belgium’s New Innovation Income Deduction Regime.” *European Taxation* 58, no. 5 (April 5, 2018): 206-09.

## **Withholding Tax on Outbound Interest Payments**

Interest paid by any Belgian company is, in principle, subject to an interest withholding tax of 30%. This domestic rate can often be reduced by bilateral tax treaties, the E.U. Interest and Royalty Directive, and several domestic exemptions that have been implemented in Belgium.

## **CAPITAL DUTY**

Pursuant to the Law of June 23, 2005, the rate of capital tax is set at 0%<sup>21</sup> for all contributions to share capital occurring on or after January 1, 2006.

## **V.A.T.**

On the basis of E.C.J. case law, a distinction is made between “active” and “passive” holding companies.<sup>22</sup> A passive holding company has no economic activity that gives entitlement to credit input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or participations. An active holding company, however, is involved in its subsidiaries’ management on the condition that these services are remunerated. To the extent that its activities are neither exempt nor outside the scope of V.A.T., an active holding company can credit input V.A.T. against output V.A.T.

Based on a response in 2010 from the Belgian Minister of Finance on a Parliamentary Question,<sup>23</sup> even V.A.T. incurred in connection to a sale of shares may, under appropriate circumstances, be creditable and refundable. This insight is derived from the E.C.J.’s ruling of October 29, 2009 in *Skatteverket v. AB SKF* (Case C-29/08). First, one should determine whether there is in principle a direct relationship between a “previous” transaction (e.g., an input transaction on which input V.A.T. is chargeable) and a “subsequent” transaction (e.g., an output transaction that is subject to output V.A.T.). If a relationship exists, the input V.A.T. can be credited. However, if there is a direct relationship between an input transaction and an output transaction that is either exempt from V.A.T. or outside the scope of V.A.T., the input V.A.T. is not creditable (as was the situation in E.C.J. Case No. C-4/94 of April 6, 1995, *BLP Group*). If no direct relationship exists between the input transaction and any output transaction, the input V.A.T. may still be creditable when the cost for the input services is part of the general expenses of the taxpayer and is included in the price charged by the taxpayer for goods delivered or services rendered.

This principle was formulated in the *Skatteverket v. SKF* case – the Belgian tax administration accepted that input V.A.T. could be creditable in the event of an issuance of new shares or the purchase of shares. However, V.A.T. credit is not available if the cost of the input transaction on which V.A.T. was charged is included in the sale price of the shares, which is either exempt or out of the scope of V.A.T. The Advocates General of the E.C.J. further clarified on May 3, 2018 that V.A.T. incurred in connection with a failed sale of shares is fully deductible under the aforementioned

<sup>21</sup> Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

<sup>22</sup> A.o., *EDM v. Fazenda Pública*, Case C-77/01, [2004] E.C.R. I-04295.

<sup>23</sup> Parl. Question, No. 299 of January 12, 2010 (Brotcorne), Q&A, Chamber 2009-2010, No. 52-102, 107.



circumstances, *i.e.*, when the services resulting in the input V.A.T. are part of the general expenses.<sup>24</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. In principle, a Private P.R.I.C.A.F. is not a holding company as such.

The Act of March, 26, 2018 and the Royal Decree of May 8, 2018 made major changes to the legal status of a Private P.R.I.C.A.F.

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.<sup>25</sup> The Private P.R.I.C.A.F. must have at least six "private investors."

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: shares, bonds, and debt instruments of all kinds; securities issued by other undertakings for collective investment; and derivative financial instruments such as subscription rights and options. Other investments are either partially and/or temporarily authorized or prohibited.

The Act 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 Federal 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.

A Private P.R.I.C.A.F. is subject to corporation income tax, but its taxable basis deviates from the normal corporation income tax regime and is limited to certain elements such as non-arm's length benefits received, nondeductible expenses, and payments in lieu of dividends in stock-lending transactions. Private P.R.I.C.A.F.'s do not pay income taxes.

The Act 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 difference between the capital invested by the private investors and 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 received by the private investors. The tax reduction is capped at €25,000 without indexation.

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<sup>24</sup> Opinion of Advocate General Kokott, *Ryanair Ltd. v. The Revenue Commissioners*, Case C-249/17 (pending case).

<sup>25</sup> Note that the Royal Decree of May 8, 2018 decreased the minimum investment threshold from €100,000 to €25,000.

*“The Act 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.”*

Dividends distributed by a Private P.R.I.C.A.F. are in principle subject to a 30% withholding tax. Several exceptions exist:

- Distributions stemming from capital gains realized on shares held by a Private P.R.I.C.A.F. are exempt from withholding tax. As of January 1, 2018, the general 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 withholding tax.
- The Act of March 26, 2018 extended the application of a reduced dividend withholding tax 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.

## **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 begun to implement (i) Action Item 5 regarding the adoption of the I.I.D. using the modified nexus approach in lieu of the P.I.D., and (ii) Action Items 8 through 10 and 13 regarding transfer pricing. 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 European Commission before taking legislative action regarding certain Action Items.

As mentioned above, on June 20, 2016, the E.U.’s Economic and Financial Affairs Council (“E.C.O.F.I.N.”) reached agreement on the draft Anti-Tax Avoidance Directive (“A.T.A.D.”), the aim of which is to harmonize the implementation of several B.E.P.S. measures at the E.U. level, such as Action Item 2 regarding hybrid mismatches, Action Item 3 regarding C.F.C. rules, and Action Item 4 regarding the interest limitation rule. Most measures must be implemented in Belgium by December 31, 2018 at the latest.

### **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>26</sup> Dividends derived from a subsidiary will be excluded from the dividends received deduction to the extent that the subsidiary has deducted, or can deduct, this income from its profit.

Definitions of “hybrid mismatch,” “hybrid entity,” and “hybrid transfer” were introduced into Belgian tax law.<sup>27</sup>

<sup>26</sup> Articles 185, 198, and 203 I.T.C.

<sup>27</sup> *Id.*, Article 2 ¶1.

A “hybrid mismatch” is an arrangement resulting in either

- a deduction of expenses for both a Belgian company or permanent establishment and a foreign enterprise or establishment thereof (“double deduction”), or
- a deduction for one of these taxpayers on an amount that is also not included in taxable income of the beneficiary (“deduction without inclusion”).

A hybrid mismatch requires associated enterprises that are part of the same group or that act under a structured arrangement. No hybrid mismatch exists where the non-inclusion is due to the application of a tax regime that derogates from the standard tax law or differences in the value attributed to a payment, including differences resulting from the application of transfer pricing rules.

A “hybrid entity” is any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction but is treated as a transparent entity under the tax laws of another jurisdiction.

A “hybrid transfer” is any arrangement to transfer a financial instrument that is treated for tax purposes as having been derived simultaneously by more than one of the parties to the arrangement.

### Taxable Hybrids

#### Disregarded Permanent Establishment Mismatch Rule

Belgian companies will be taxed on profits attributable to a foreign permanent establishment in another E.U. Member State that were exempt in that Member State under a tax treaty. Note that the profits must have been realized due to a hybrid mismatch arrangement and must not be recognized as taxable in the permanent establishment’s jurisdiction.

#### 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

*“Effective as of tax assessment year 2019, the N.I.D. will be applicable only to the increase in qualifying equity rather than the amount of the qualifying equity of the previous tax year.”*

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 will not be 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 that is non-dual inclusion income. A deduction will be allowed, however, if the other jurisdiction is an E.U. Member State with which Belgium has concluded a tax treaty that determines the company will be treated as a Belgian-resident taxpayer.

Most of the above rules will be applicable as of assessment year 2020 (book years ending December 31, 2019 or later).

### **B.E.P.S. Action 3: C.F.C. Rules**

Belgium may not have C.F.C. legislation in place yet, but it has extensive anti-abuse rules with 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.

Recently, Belgium adopted legislation introducing a look-through tax sometimes referred to as a “Cayman tax” for income derived by individual taxpayers from the use of foreign vehicles such as trusts or foundations. These “juridical arrangements” must be reported on the individual’s personal income tax return as of tax year 2014, 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 only target income derived by a C.F.C. through non-genuine arrangements set up for the essential purpose of obtaining a tax advantage.<sup>28</sup>

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. will be deemed to be low taxed if it is not subject to any income tax or is subject to income tax at a rate that is less than half the rate that would be imposed were it a resident of Belgium.<sup>29</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.”), own business assets, or assume risks, then the arrangement is considered to be non-genuine. In

<sup>28</sup> Article 185/2 ¶1 I.T.C.

<sup>29</sup> *Id.*, ¶2.

comparison, income that is generated through assets and/or risks connected to the performance of S.P.F.'s by a Belgian taxpayer will be 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, these profits will be fully deductible based on Belgian C.F.C. rules.

#### **B.E.P.S. Action 4: Excessive Interest Deductions**

Similar to most other countries, Belgium already has various rules limiting excessive interest deductions. The most well-known rule is the thin capitalization rule, which imposes a debt-to-equity ratio of 5:1. It is not clear whether the Belgian thin capitalization rule should be tightened and expanded to apply to interest on all debt owed by a domestic corporation.

In any event, Belgium implemented the A.T.A.D. by providing an interest limitation rule to discourage companies from creating artificial debt arrangements designed to minimize tax. Interest is deductible only up to a certain amount: the greater of either 30% of an entity's tax-adjusted earnings before interest, taxes, depreciation, and amortization, or €3 million. With the Law of December 25, 2017, Belgium transposed this rule into national law.<sup>30</sup> As expected, 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*, a change in the duration of the loan, the interest rate due under the loan, or a party to the loan. No further guidance is available as of June 15, 2018. Additionally, financial institutions are carved out of the interest limitation rule altogether.

#### **B.E.P.S. Actions 8, 9, 10, and 13: Transfer Pricing**

Belgium has transfer pricing rules in place to avoid profit shifting, and in recent years the number of transfer pricing audits has increased 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.

The Belgian Minister of Finance has stated that, as part of the B.E.P.S. Project, the Belgian government envisages introducing formal transfer pricing documentation requirements which would contribute to more transparency and more efficient tax audits. He also announced that the specialized transfer pricing investigation team will continue to conduct transfer pricing audits in Belgium.

On July 1, 2016, the Belgian Parliament passed legislation to introduce specific transfer pricing documentation requirements based on B.E.P.S. Action 13. This means that the O.E.C.D.'s recommended three-tiered approach to transfer pricing documentation will be 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



<sup>30</sup> Article 40 of the Law of December 25, 2017 on the Corporate Income Tax Reform, introducing Article 198/1 of the I.T.C., to take effect on January 1, 2020. *Belgian State Gazette*, December 29, 2017.

Belgian company, and if it has gross consolidated revenue of at least €750 million, it will also have to file a country-by-country report with the Belgian tax authorities within 12 months after the closing of the consolidated financial statements of the group.

### **F.A.T.C.A.**

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 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 financial institutions. The withholding tax applies to payments made by all persons, even those unrelated to the U.S. account in issue.

## **INCOME TAX TREATIES**

As of January 1, 2018, Belgium has in effect 94 income tax treaties with the jurisdictions listed below.

Albania	Algeria	Argentina	Armenia
Australia	Austria	Azerbaijan	Bahrain
Bangladesh	Belarus	Bosnia & Herzegovina	Brazil
Bulgaria	Canada	Chile	China
Congo (Dem. Rep.)	Croatia	Cyprus	Czech Republic
Denmark	Ecuador	Egypt	Estonia
Finland	France	Gabon	Georgia
Germany	Ghana	Greece	Hong Kong
Hungary	Iceland	India	Indonesia
Ireland	Israel	Italy	Ivory Coast
Japan	Kazakhstan	Kuwait	Kyrgyzstan
Latvia	Lithuania	Luxembourg	Macedonia
Malaysia	Malta	Mauritius	Mexico
Moldova	Mongolia	Montenegro	Morocco
Netherlands	New Zealand	Nigeria	Norway
Pakistan	Philippines	Poland	Portugal
Romania	Russia	Rwanda	San Marino
Senegal	Serbia	Seychelles	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sri Lanka	Sweden	Switzerland
Taiwan	Tajikistan	Thailand	Tunisia
Turkey	Turkmenistan	Ukraine	United Arab Emirates
United Kingdom	United States	Uruguay	Uzbekistan
Venezuela	Vietnam		

On June 7, 2017, 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.

The M.L.I. has not yet been ratified by the various competent legislative bodies in Belgium, and this is not expected to happen until 2021 at the earliest. Belgium submitted reservations against, *inter alia*, the agency permanent establishment provision. Regarding the options for the application of methods for the elimination of double taxation provided for in the M.L.I., Belgium has changed its position and 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.

## SWEDEN

### Author

Peter Utterström

*Peter Utterström Advokat AB  
Stockholm, Sweden*

### IN GENERAL

Sweden has emerged as an attractive country for establishing financing and holding companies for both E.U. and non-E.U. corporations. However, modifications in recent years, e.g., intra-group interest restrictions, have affected this status adversely, although perhaps no more adversely than other countries that have implemented 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 80 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains;
- a low corporation income tax rate (*i.e.*, 22%) with indications that it may drop further;
- relatively low requirements on minimum share capital – SEK 50,000 (approx. €5,000); and
- no withholding tax on dividend distributions to qualified U.S. shareholders (with a minimum holding of 80% of the votes and minimum holding period of 12 months) or 5% withholding tax for holdings amounting to 10% or more of the votes (with no holding period requirement).

The author would like to acknowledge the contribution of Daniel Gustafsson, an assistant judge at the Administrative Court of Stockholm, in the preparation of this article.

The main legal entity used for holding and financing purposes is the Swedish limited liability company (“*Aktiebolag*” or “A.B.”). The A.B. has both legal competence and the formal capacity to act as a party before authorities and courts, and it is a legal entity for Swedish tax purposes. An A.B. is also a qualifying entity under the Swedish participation exemption.

### PARTICIPATION EXEMPTION

#### **General**

The net income of a Swedish company is normally subject to corporation income tax at a rate of 22%. However, if both the holding company and the subsidiary are qualifying entities under the participation exemption, income from capital gains and

dividends are tax exempt. According to Chapter 24 of the Swedish Income Tax Act (“I.T.A.”), the holding entity must be in one of the following forms in order to qualify:

- A Swedish A.B. or a Swedish economic association that is not an investment company
- A Swedish foundation or a Swedish non-profit association that is not subject to tax exemption according to Chapter 7 I.T.A.
- A Swedish savings bank
- A Swedish mutual insurance company
- A “foreign company” resident within the E.E.A. that is the equivalent of any of the foregoing entities

The term “foreign company” is defined in the I.T.A. as a foreign legal entity that is subject to tax in its country of residence, if such taxation is similar to the taxation of a Swedish A.B. In general, a tax rate of 60% of the Swedish statutory rate is acceptable, *i.e.*, currently 14% (60% of 22%) or more. Also, a foreign legal entity resident in a country with which Sweden has signed a double tax treaty is always deemed a “foreign company” if the entity is entitled to the benefits of the treaty and the treaty is not limited to certain types of income.

The share held must be a share in an A.B., an economic association, or a similar foreign entity (see **Qualifying Foreign Entities** below). The share must also be a capital asset, 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.

*“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.”*

## **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. So far, a large number of foreign legal entities have been deemed to correspond to Swedish A.B.’s by the Supreme Administrative Court and the Board for Advance Tax Rulings.

## **WITHHOLDING TAX**

### **Outbound Dividends**

Under the Swedish Withholding Tax Act (“W.T.A.”), a 30% withholding tax is levied upon the distribution of dividends by a Swedish A.B. However, due to the implementation of the E.U. Parent-Subsidiary Directive (“P.S.D.”) and Sweden’s extensive network of double tax treaties, withholding tax will not be imposed or will be imposed at a reduced rate in most cases. Under the double tax treaty concluded between the U.S. and Sweden, for instance, Sweden may not impose withholding tax on dividends if the U.S. holding in the Swedish company amounts to at least 80% of the votes and has been in place for at least one year. If the size of the holding is below 80% but amounts to 10% or more of the votes, the withholding tax rate is instead reduced to 5% of the gross amount distributed.

Dividends distributed to a legal entity resident within the E.U. are exempt from withholding tax if the recipient holds at least 10% of the share capital in the distributing company and fulfills the conditions set forth in Article 2 of the P.S.D.

Additionally, if the shares in the distributing company are deemed business-related shares under the participation exemption regime and the dividend (or capital gains at disposal of the shares) would have been tax exempt if the entity holding the shares had been a Swedish company, the dividend is exempt from withholding tax.

## **Inbound Dividends**

Withholding tax on distributions from foreign subsidiaries is often eliminated under the P.S.D. or reduced under a double tax treaty (see **Treaty Chart** below).

## **Treaty Chart**

Sweden currently has over 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	Argentina	Armenia	Aruba
Australia	Austria	Azerbaijan	Bangladesh
Barbados	Belarus	Belgium	Bermuda
B.E.S. Islands	Bolivia	Bosnia & Herzegovina	Botswana
Brazil	British Virgin Islands	Bulgaria	Canada
Cayman Islands	Chile	China	Croatia
Curaçao	Cyprus	Czech Republic	Denmark
Egypt	Estonia	Faeroe Islands	Finland
France	Gambia	Georgia	Germany
Greece	Guernsey	Hungary	Iceland
India	Indonesia	Ireland	Isle of Man
Israel	Italy	Jamaica	Japan
Jersey	Kazakhstan	Kenya	Latvia
Lithuania	Luxembourg	Macedonia	Malaysia
Malta	Mauritius	Mexico	Montenegro
Namibia	Netherlands	Netherlands Antilles	New Zealand
Nigeria	Norway	Pakistan	Philippines
Poland	Portugal	Romania	Russia
Saudi Arabia	Serbia	Singapore	Slovakia
Slovenia	South Africa	South Korea	Spain
Sri Lanka	St. Martin	Switzerland	Taiwan
Tanzania	Thailand	Trinidad & Tobago	Tunisia
Turkey	Turkmenistan	Ukraine	United Kingdom
United States	Venezuela	Vietnam	Zambia
Zimbabwe			

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

## **FINANCING**

### **Loan Financing**

As a general rule, all interest payments are deductible without limitation. Sweden does not impose withholding tax on interest payments. As there are no thin capitalization rules (*i.e.*, interest deductibility is not dependent on the fact that a certain

debt-to-equity ratio is upheld), highly leveraged structures can be used.

From a transfer pricing perspective, the interest rates charged must be at arm's length. Interest rates charged between related parties may be – and most often are – challenged by the Swedish Tax Agency (“S.T.A.”).

Limitations exist on deductions for interest expense attributable to loans from affiliated companies. Interest charged to the Swedish company will qualify for tax deduction only in cases where debt financing is in place for commercial reasons. This regulation is a reaction to the seemingly widespread practice of employing Swedish tax structures to reduce Swedish corporate taxation using intercompany loans from low tax jurisdictions.

### **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 is indirectly a deductible expense for the contributor, since the contribution is added to the tax basis of the shares and is thus deductible when calculating future capital gains or losses – if the investment is a taxable investment – on the disposal of the shares.

A conditional contribution is deemed to be a loan for tax purposes. Repayment of a conditional contribution is not regulated in Swedish tax law, but according to case law, a repayment is generally treated as the repayment of a loan and, thus, is not a taxable event, unless special circumstances are at hand.

Sweden does not impose any transfer tax or stamp duty on equity contributions.

## **LIQUIDATION**

### **Distributions**

Under the I.T.A., the liquidation of a company is deemed a taxable disposal of the shares issued by the liquidated company. Thus, an individual shareholder is normally taxed on the difference between the amount distributed during the liquidation and his/her tax basis in the shares. If the shares are business-related shares, no capital gains or losses will be recognized. For foreign shareholders, a distribution in connection with the liquidation of a company is deemed to be a distribution of a dividend. Thus, withholding tax will be levied on the distributed (gross) amount unless 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 reimbursement for the amount of withholding tax paid which exceeds the amount of tax imposed on the difference between the distributed amount and the acquisition value. However, as mentioned in **Withholding Tax** above, withholding tax will in most cases be eliminated or imposed at a reduced rate.

### **Losses**

Final losses on the liquidation of foreign subsidiaries give rise to a special group

deduction (“*koncernavdrag*”). The deduction is a result of Sweden becoming an E.U. Member State. However, it applies only in very restricted circumstances, as illustrated by the following conditions, which must be met in order for a group deduction to be allowed:

- The foreign subsidiary must be located within the E.U.
- The foreign subsidiary must be liquidated.
- Until the liquidation is completed, the foreign subsidiary must have been wholly-owned either during the entire fiscal year of both the parent and the subsidiary, or since it started conducting business of any kind.
- The deduction of the group contribution must be made in connection with the tax assessment of the fiscal year during which the liquidation is completed.
- The deduction of the group contribution must be openly disclosed in the tax assessment of the parent company.
- None of the companies within the parent company’s community of interests may conduct business in the domicile state of the subsidiary after the completion of the liquidation.

A loss is considered final only if the subsidiary, or another 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.

*“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.”*

The above applies only to N.O.L.'s incurred during past fiscal years. N.O.L.'s incurred during the current fiscal year – the year of acquisition – are not subject to any restriction.

## TRANSFER PRICING

Sweden applies a transfer pricing provision based on the O.E.C.D.'s arm's length principle. In practice, this means that prices charged between related parties must be set in accordance with market rates. If internal pricing deviates from the rates charged by independent parties and the taxable result of the Swedish company is therefore reduced, the S.T.A. may challenge the taxable result. Additionally, Swedish companies are required to keep documentation on cross-border transactions with related parties.

In order to avoid future transfer pricing conflicts with the S.T.A., it is possible to apply for a binding Advance Pricing Agreement (“A.P.A.”). The fee for obtaining an A.P.A. is currently SEK 150,000 (approximately €15,000). The agreement is normally valid for three to five taxable years.

As is the case in other countries, the S.T.A. has increased its focus on transfer pricing matters in recent years. It is likely that the abovementioned rules will be modified as a result of the O.E.C.D.'s initiative to combat base erosion and profit shifting (the “B.E.P.S. Project”) and there is a clear trend that the S.T.A. will be more aggressive in challenging intercompany pricing and transactions. Accordingly, the S.T.A. will likely further enhance its focus on intercompany transactions and the requirements for documentation and information from the taxpayer. Additional comments on B.E.P.S. will be made separately, under **Base Erosion and Profit Shifting** below.

## CONTROLLED FOREIGN CORPORATIONS

The purpose of the Swedish controlled foreign corporation (“C.F.C.”) rules is to prevent Swedish persons or companies from deferring or avoiding taxation by collecting funds in a foreign subsidiary resident in a low tax jurisdiction. If a foreign subsidiary is deemed to be a C.F.C., a shareholder subject to tax in Sweden will be taxed directly for an appropriate share of the C.F.C.'s profit – as calculated under Swedish generally accepted accounting principles and tax rules, irrespective of whether any funds have been distributed. Any tax paid in the foreign jurisdiction is creditable against Swedish tax.

In order for the C.F.C. rules to be applicable, the foreign corporation must be subject to low tax, which is defined as a tax rate lower than 55% of the Swedish corporate tax rate (*i.e.*, 12.1%). The controller (*i.e.*, the person subject to C.F.C. taxation) must own or control at least 25% of the capital or votes of the foreign corporation alone or together with persons in a communal interest with the controller.

There are two exceptions from the C.F.C. rules:

- First, regardless of the level of taxation, a foreign legal entity is deemed not to be a C.F.C. if it is resident for tax purposes in a country mentioned on the so-called “whitelist.” If Sweden has concluded a double tax treaty with such a country, the exception from the C.F.C. rules is only applicable on income

that falls within the scope of the treaty.

- Second, if the C.F.C. is resident for tax purposes within the E.E.A. and is deemed to be a “real establishment” from which a commercially motivated business is conducted, the C.F.C. rules are not applicable.

## BASE EROSION AND PROFIT SHIFTING

Sweden has slowly taken an increased interest in combatting B.E.P.S. and in the development of the B.E.P.S. Project at the level of the O.E.C.D. As of May 2018, the influence of the B.E.P.S. Project is mainly seen in legal debates and, possibly, in tax courts. No new Swedish regulations, recommendations, or case law developments have come, specifically, out of the B.E.P.S. Project, with the exception of legislation enacted in 2017 to implement B.E.P.S. Action 13 on transfer pricing documentation and country-by-country reporting.

Until recently, the B.E.P.S. Project has primarily had only an indirect effect in Sweden. This has begun to change as, in 2018, the Swedish government proposed major changes to the I.T.A. concerning corporate income tax. The bill includes a general limitation of interest deductibility to 30% of E.B.I.T.D.A., modifications to the current intra-group interest restrictions, and a phased-in reduction of the corporate income tax rate to 20.6% in 2021. In addition, interest deduction limitation rules aimed at hybrid mismatch arrangements and specific tax rules concerning financial leasing agreements have been proposed. If adopted, the new legislation is expected to enter into force on January 1, 2019. However, as 2018 is an election year in Sweden, exactly how these proposals will fare is for the moment uncertain.

Beyond the prospects of 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 the S.T.A. (and its Nordic counterparts) will be even more active in issues concerning permanent establishments, transfer pricing, and intercompany transactions. Information exchange – whether as a result of B.E.P.S., F.A.T.C.A., or the Common Reporting Standard (“C.R.S.”) – will also trigger more activities. Long term, it is assumed that the B.E.P.S. Project will trigger an increased documentation and compliance burden for taxpayers, but not necessarily much new legislation or changes to the I.T.A. It is important to keep in mind that many of the B.E.P.S. Actions will not require an actual change of law (as effected ultimately by the Swedish Parliament), but a change of the O.E.C.D. Guidelines, which will be utilized as a point of reference by the S.T.A. and implemented by the tax courts. In this context, legislators in most countries have been driven by media attacks on the tax planning methods of multinational groups, and the likely effect is that more “double taxation” will occur in order to prevent “double nontaxation.”



# DENMARK

## Author

Nikolaj Bjørnholm  
Bjørnholm Law  
Copenhagen, Denmark

## IN GENERAL

For years, Denmark has been attractive to foreign investors for several commercial reasons, such as its highly developed infrastructure, well-educated populace, and uncomplicated rules governing the termination of employment.

The investor-friendly environment is supported by a corporate tax regime primarily designed for operating entities, which generally allows for

- a corporation income tax rate of 22%;
- zero corporate tax on inbound dividends received by a Danish company with a participation of at least 10% in a subsidiary situated in the E.U. or a country which has a double tax treaty with Denmark, or if the Danish company and the subsidiary are eligible for tax consolidation;
- zero withholding tax on outbound dividends to corporate parents having a participation of at least 10% that are resident in the E.U./E.E.A. or treaty countries (subject to an anti-abuse rule discussed below); and
- reduced tax on inbound and outbound dividends on portfolio shares (shareholdings of less than 10%) due to a strong network of tax treaties with approximately 80 countries.

The Danish corporate tax regime also provides for 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 (see **Capital Gains Taxation** below)
- No wealth tax on foreign investors within the holding period
- No exit tax on foreign investors (foreign investors are not subject to limited Danish tax liability on their disposal of shares in a Danish company)
- A flexible corporation law regime with no red tape

On the other hand, some Danish rules have proven to discourage or hamper investments, such as 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, 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”) (See **Tightening of Rules for Dividend Withholding Tax Exemption** below)

## CORPORATION INCOME TAX

A Danish company is subject to Danish income taxation at a flat rate of 22%. This rate applies whether or not profits are distributed.

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

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

## WITHHOLDING TAX IN FOREIGN SUBSIDIARY’S COUNTRY

Dividends paid by a foreign subsidiary to a Danish holding company may be subject to withholding tax, which may be eliminated or reduced pursuant to the P.S.D. or a tax treaty concluded by Denmark and the foreign subsidiary country.

As of June 1, 2018, Denmark has income tax treaties in effect with the following jurisdictions:

*“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.”*

Argentina	Armenia	Australia	Austria
Azerbaijan	Bangladesh	Belarus	Belgium
Bermuda	B.E.S. Islands	Brazil	British Virgin Islands
Bulgaria	Canada	Cayman Islands	Chile
China	Croatia	Curaçao	Cyprus
Czech Republic	Egypt	Estonia	Faeroe Islands
Finland	Georgia	Germany	Ghana
Greece	Greenland	Guernsey	Hungary
Iceland	India	Indonesia	Ireland
Isle of Man	Israel	Italy	Jamaica
Japan	Jersey	Kenya	Kuwait
Kyrgyzstan	Latvia	Lithuania	Luxembourg
Macedonia	Malaysia	Malta	Mexico
Montenegro	Morocco	Netherlands	New Zealand
Norway	Pakistan	Philippines	Poland
Portugal	Romania	Russia	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Sri Lanka	St. Martin	Sweden
Switzerland	Taiwan	Tanzania	Thailand
Trinidad & Tobago	Tunisia	Turkey	Uganda
Ukraine	United Kingdom	United States	Venezuela
Vietnam	Zambia		

Denmark has concluded limited tax information exchange agreements (“T.I.E.A.’s”) with the following jurisdictions:

Andorra	Anguilla	Antigua & Barbuda	Aruba
Bahamas	Bahrain	Barbados	Belize
Botswana	Brunei	Cook Islands	Costa Rica
Dominica	Gibraltar	Grenada	Guatemala
Liberia	Liechtenstein	Macao	Marshall Islands
Mauritius	Monaco	Netherlands Antilles	Niue
Panama	Qatar	Samoa	San Marino
St. Kitts & Nevis	St. Lucia	St. Vincent & the Grenadines	Seychelles
Turks & Caicos	Vanuatu		

Treaties confined to individuals, international shipping, air transport, and Mutual Agreement Procedures have been concluded with Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, Hong Kong, the Isle of Man, Jersey, and Jordan. Denmark has further ratified the launch of the Convention on Mutual Administrative Assistance in Tax Matters, developed by the O.E.C.D. and the Council of Europe, including the 2010 protocol. More than 84 countries have also ratified the convention. Denmark has also signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

## CORPORATE TAXATION OF INBOUND DIVIDENDS

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

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

If the Danish company directly or indirectly holds less than 10% of the foreign subsidiary, 70% of the dividend payment will be subject to tax at the standard corporation income tax rate of 22%.

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

## C.F.C. TAXATION

Danish tax law contains controlled financial company (“C.F.C.”)<sup>1</sup> provisions, which apply to financial subsidiaries in all jurisdictions including Denmark, with no regard to the subsidiary’s tax burden.

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

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

- The Danish company and the foreign subsidiary are group-related (see **Interest Withholding Tax and Check-the-Box Countermeasures** below).

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<sup>1</sup> Although internationally “C.F.C.” is often defined as a “controlled foreign corporation,” here the term “controlled financial company” is used as Danish C.F.C. legislation is not confined solely to foreign entities.

Generally, group-relation exists if the Danish company directly or indirectly holds more than 50% of the foreign subsidiary's voting rights.

- The C.F.C. income comprises more than half of the aggregate taxable income of the foreign subsidiary.
- The subsidiary's financial assets represent more than 10% of its total assets.

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

- Net interest income
- Net gains on receivables, debts, and financial instruments
- Certain commissions
- Dividends
- Net capital gains on shares, but only to the extent that they are taxable under Danish law<sup>2</sup>
- Royalty payments and capital gains arising from intellectual property rights, unless the intellectual property arose from the subsidiary's own research and development activities and the payments in issue are made by an unrelated party
- Deductions claimed for tax purposes by a Danish company that relate to the income items listed above
- Leasing income deriving from financial leases including losses and gains on the assets involved
- Income from insurance, banking, and other financial activities, unless an exemption is otherwise applied for
- Gains and losses from sale of CO<sub>2</sub> credits and CO<sub>2</sub> quotas

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

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

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

- The financial assets on which the yield/gains are tax exempt, such as subsidiary investments where the subsidiary owns at least 10% of the share

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<sup>2</sup> Consequently, dividends and capital gains that benefit from the Danish participation exemption are not considered to be tainted income.

*“Danish-resident companies are exempt from tax on gains realized on shareholdings of 10% or more.”*

capital and the subsidiary is not considered as a trader in securities, are not included.

- The shares in lower-tier subsidiaries, which are controlled by the subsidiary and located in the same jurisdiction as the subsidiary, are not included. Instead, the financial assets in the lower-tier subsidiaries are included proportionately in accordance with the subsidiary's direct or indirect ownership share.

## CAPITAL GAINS TAXATION

Danish-resident companies are exempt from tax on gains realized on shareholdings of 10% or more. Capital gains realized by a Danish-resident company on shareholdings below 10% in a non-listed company are generally also tax exempt.

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

Share gains derived by a Danish company that do not qualify for tax exemption are subject to tax at the standard corporation income tax rate of 22%.

In general, a nonresident company is exempt from Danish tax on gains realized 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 foreign entity transfers shares held in a group-related Danish entity to another group-related entity for consideration consisting of assets other than shares in the group entity effecting the acquisition; and
- the 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>3</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.

Further, an anti-avoidance rule dictates that payments received by a foreign entity in connection with a transfer of shares will be considered a taxable dividend payment if

- the receiving company is without any economic risks from commercial activity;
- the payment consists of assets other than shares in the group entity effecting

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<sup>3</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.

the acquisition; and

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

In order to prevent circumvention of the anti-avoidance rule through intercompany sales, commercial activity acquired from a related legal entity less than three years before the sale of shares is not regarded under the “economic risk assessment.” For the definition of a related legal entity, see **Thin Capitalization** below.

A company without any economic risks from commercial activity is a company where the commercial activity has stopped or where the commercial activity is insignificant.

## INTEREST DEDUCTIBILITY LIMITATIONS

Interest expense incurred by corporations is generally deductible in computing taxable income provided that the underlying debt reflects a binding legal commitment to repay the face amount borrowed. Interest paid to related parties must be calculated on an arm’s length basis. Interest expense incurred on certain debt owed to the government is not tax deductible. An example is the interest that accrues on unpaid tax.

### **Thin Capitalization**

Denmark has enacted thin capitalization rules regarding intercompany debt, which may limit the deductibility of interest on debt owed to group-related entities (“Controlled Debt”). These thin capitalization restrictions apply only to the extent that the Danish company has Controlled Debt exceeding a *de minimis* threshold of DKK 10,000,000 (approximately €1,343,000 as of June 15, 2018). Further, the thin capitalization rules only apply to the extent that the debt-to-equity ratio exceeds 4:1. In such a case, the limitation of the interest deduction applies to the portion of the Controlled Debt that exceeds the 4:1 threshold. Taxpayers that have such excess debt are typically advised to convert the excess into equity to avoid the limitation of deductibility.

For the purposes of the thin capitalization rules, Controlled Debt means debt owed by a Danish debtor company (the “Danish Debtor”) to a Danish or foreign related legal entity. A related legal entity is a legal entity that

- is controlled by the Danish Debtor,
- controls the Danish Debtor, or
- is group-related with the Danish Debtor.

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

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

To combat aggressive use of hybrid entities that are treated as disregarded entities under U.S. tax law, those disregarded entities are considered under the above definitions. Consequently, fiscally-transparent entities may be considered entities that have separate legal personality and identity for purposes of the thin capitalization rules if they “are governed by rules of corporate law, a corporate law agreement or articles of association.”

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

### **Additional Limitations**

The Danish corporate tax regime includes two additional limitations on the deductibility of financial expenses that apply to Controlled Debt and third-party debt.

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

- A limitation based on debt-to-equity ratio (the thin capitalization rules, see **Thin Capitalization**)
- A limitation based on the tax value of assets (“Asset Limitation Rule”), entailing that net financing expenses exceeding DKK 21,300,000 (approximately €2,860,000 as of June 15, 2018) are deductible up to a cap of 2.9% (2018 figure) of the tax basis of the Danish operating assets
- A limitation based on annual profits (“E.B.I.T. Limitation Rule”), entailing a maximum interest deduction of 80% of E.B.I.T., which only applies if the net financing expenses exceed DKK 21,300,000 (approximately €2,860,000 as of June 15, 2018)

### **Calculation of Net Financial Expenses**

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

- taxable interest income and deductible interest expense (excluding interest income/expense from trade debtors and creditors);
- loan commission fees and similar expenses;
- taxable capital gains and losses on claims, debts, bonds, and financial instruments (excluding gains/losses on claims acquired in trade if the contracting party is a related party);
- gains/losses on forward contracts relating to the hedging of operating income (provided that the forward contracts are not acquired in trade);



- deemed finance charges relating to financial leasing arrangements (defined in accordance with I.A.S. 17);
- taxable capital gains and deductible capital losses; and
- taxable dividends.

Interest expense and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses. The calculation of net financial expenses is made on a group basis for Danish companies, which are subject to Danish tax consolidation. If the Danish company/group has net financial expenses exceeding the DKK 21,300,000 threshold, such net financial expenses will be subject to restrictions under the Asset Limitation Rule and the E.B.I.T. Limitation Rule as discussed below.

### **Restrictions Under the Asset Limitation Rule**

Net financial expenses in excess of DKK 21,300,000 will be deductible only in an amount corresponding to 2.9% of the tax value of certain assets.

For the purposes of computing the 2.9% ceiling, only certain qualifying assets are considered, including, *inter alia*, the following:

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

Shares are not considered qualifying assets. Claims, notes, and financial instruments are not considered qualifying assets, either. This means that the value of the foreign exchange notes to be purchased by Danish Newco will not be included in the computation of the 2.9% ceiling. For companies subject to Danish tax consolidation, the computation of the 2.9% ceiling is made on a consolidated basis.

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

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

Net financing expenses below DKK 21,300,000 will never be restricted under the E.B.I.T. Limitation Rule, but may be restricted under the thin capitalization rules which, however, only apply on Controlled Debt. The DKK 21,300,000 ceiling (which is not adjusted annually) is calculated on a group basis for Danish companies that are subject to Danish tax consolidation.

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

## WITHHOLDING TAX ON OUTBOUND DIVIDENDS

Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for an elimination or reduction of the Danish withholding tax by virtue of the P.S.D. (as amended by Council Directive 2015/121/E.U.) or a tax treaty between Denmark and the parent company's state of residence. If these conditions are not met, a 27% withholding tax is levied, subject to a subsequent refund of 5 percentage points for any corporation, irrespective of location, or a lower withholding tax rate if provided by treaty.

## TIGHTENING OF THE RULES FOR DIVIDEND WITHHOLDING TAX EXEMPTION

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

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

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

## BASE AND EROSION PROFIT SHIFTING

Denmark has already implemented many B.E.P.S. Actions in Danish law and 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** below discussing §2A of the Danish Corporation Tax Act, which has been enacted to counteract U.S.-Danish check-the-box structures. Further, debt to foreign persons or entities is deemed equity if the debt is treated as equity in the lender's country of residence. This rule is not triggered if the lender is taxed on the yield as interest in the lender's country of residence.

With respect to Action Item 3 on C.F.C. Taxation, see **C.F.C. Taxation** above. As described, Denmark has implemented detailed C.F.C. rules, which are generally

*“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.”*

wide in scope.

With respect to Action Item 4 on limiting base erosion via interest deductions, see **Interest Deductibility Limitations** above. As is evident, Denmark operates strict measures to counteract base erosion through the use of excessive interest payments. These rules are supplemented by the anti-avoidance rule mentioned above, whereby debt to foreign lenders is treated as equity in Denmark if the loan is treated as equity in the lender’s country of residence. Denmark also employs an aggressive approach when assessing the terms of intra-group loans and will generally challenge excessive interest payments out of Denmark.

With respect to Action Item 5, Denmark has concluded a number of treaties on exchange of information with various tax havens to ensure a well-founded basis for taxation in Denmark.

With respect to Action Item 6 on preventing treaty abuse, see **General Anti-Abuse Clauses** below, which outlines the contents of two newly-introduced general anti-abuse clauses. As these treaty abuse rules were only recently adopted, the scope of their implementation is not yet clear.

With respect to Action Items 8, 9, and 10, see **Transfer Pricing** below on the Danish transfer pricing rules. The arm’s length principle in Danish law is defined in accordance with O.E.C.D. Guidelines, and the Danish tax authorities recognize the methods set out in the guidelines.

## GENERAL ANTI-ABUSE CLAUSES

Denmark has 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 (2003/49/E.C.), and the Merger Directive (2009/133/E.C.). The E.U. tax directive G.A.A.R. implements the mandatory G.A.A.R. of the P.S.D. (amendment by Directive 2015/121/E.U.).

The tax treaty G.A.A.R. is worded slightly differently than the E.U. tax treaty G.A.A.R. but 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.

The newly-introduced G.A.A.R.’s entail that taxable persons will not benefit from the P.S.D., the Interest and Royalty Directive, the Merger Directive, and tax treaties if the principal purpose of a transaction or arrangement is to achieve a tax benefit which is not in accordance with the directives or the tax treaty and which is artificial in nature.

Thus far, the Danish courts have applied certain measures to disregard transactions carried out for tax purposes (namely the “substance over form” doctrine).

The explanatory remarks accompanying the newly-introduced bill state that the new G.A.A.R.’s may have a wider scope than the existing doctrine of “reality in transactions,” but fail to specify in which situations the G.A.A.R.’s are applicable.

The newly introduced G.A.A.R.’s raise serious uncertainty with respect to international

tax planning, as it is unclear to what extent the Danish tax authorities can and will try to deny the benefit of the E.U. tax directives and double tax treaties to taxable persons seeking to reduce tax liability.

It is expected that Danish tax authorities will issue further guidance on how the G.A.A.R.'s are to be applied in practice. Until then, great uncertainty remains.

## INTEREST WITHHOLDING TAX AND CHECK-THE-BOX COUNTERMEASURES

As a starting point, a 22% withholding tax applies to interest payments made by a Danish company to a foreign related entity. (See definition of related legal entity above in **C.F.C. Taxation** above.) However, a foreign related lender will be exempt from Danish interest withholding tax if it falls into one of the following categories:

- The foreign related lender has a permanent establishment in Denmark to which such interest income is attributed.
- The foreign related lender is protected under the Interest and Royalty Directive (2003/49/E.U.) (no tax is levied and no withholding tax applies).
- The foreign related lender is protected under a tax treaty with Denmark (irrespective of treaty rate).
- The foreign related lender is controlled (as defined under Danish C.F.C. rules) by a Danish entity.
- The foreign related lender is controlled by a party resident in a country that has concluded a tax treaty with Denmark, and further, that such country may tax the lender on such interest payments pursuant to C.F.C. taxation rules of that country.
- The foreign controlling or group-related lender can demonstrate that it has paid foreign income tax on the interest received at a rate of at least 16.5%, equivalent to three-fourths of the normal Danish flat corporate tax rate, and further provides that it has not entered into a back-to-back loan with an entity that has paid foreign income tax on the interest received at a rate of less than 16.5%.

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

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

- The Danish company, according to the rules of a foreign state, is treated as a fiscally-transparent entity, whereby the income of the company is included

in the taxable income of a controlling foreign legal entity, *i.e.*, an entity that owns directly or indirectly more than 50% of the Danish company or holds more than 50% of the voting rights (see the definition of control in **Interest Deductibility Limitations**).

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

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

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

Further, certain tax consolidation rules such as those in the U.S. may be considered to have the same effect as fiscal transparency and therefore may trigger §2A status. The paradigm is a U.S. company that has a branch in Denmark. The U.S. company or head office may be deemed transparent under Section 2A if the head office is tax consolidated with the parent company of a U.S. affiliated group and all members of the affiliated group. In such an event, payments made by the Danish branch to the parent company or any member of a U.S. affiliated group would be considered to be within the same legal entity and thus not deductible.

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

## TRANSFER PRICING

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

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

*“Certain tax consolidation rules such as those in the U.S. may be considered to have the same effect as fiscal transparency and therefore may trigger §2A status.”*

and terms of the transactions with related parties. Documentation may be prepared in Danish, Swedish, Norwegian, or English.

Small- and medium-sized companies are relieved of the obligation to prepare documentation. These businesses are only required to prepare documentation for transactions with related companies resident outside the E.U., and only if Denmark does not have a double tax treaty with the country in question. Small- and medium-sized companies include companies which, on a consolidated basis, have (i) less than 250 full time employees during a year, and (ii) either assets below DKK 125,000,000 (approximately €16,786,000 as of June 15, 2018) or turnover below DKK 250,000,000 (approximately €33,572,000 as of June 15, 2018).

The penalty for noncompliance is calculated on different objective criteria and based on the potential tax advantage. However, a fixed penalty of DKK 250,000 (basic amount) applies, plus 10% of the increased income if noncompliance resulted in economic gain.

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

## GROUP OF COMPANIES – JOINT CROSS-BORDER TAXATION

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

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

- has the majority of the voting rights in another company;
- is a shareholder and has the right to appoint or dismiss a majority of the members of another company's management;
- is a shareholder and is entitled to exercise control over another company's operational and financial management on the basis of the articles of association or agreement with that other company;
- is a shareholder and controls the majority of the voting rights in another company on the basis of a shareholder's agreement; or

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

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

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

The ability to claim a benefit from a loss carryforward is limited. A loss of DKK 8,205,000 (2018 figure) can be offset against positive income in the carryover year. The remaining loss can reduce up to 60% of the remaining income. Any remaining loss can be carried forward indefinitely. Net operating loss carrybacks are not allowed.

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

## INTERIM DIVIDENDS

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

## BINDING ADVANCE RULING

Binding rulings, including advance rulings, on specific proposed transactions can be obtained from the Danish Tax Authority. A fee (currently approximately €50 as of June 18, 2018) 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.

*“Danish companies and Danish branches of foreign companies, which are group-related as defined below, are subject to mandatory Danish tax consolidation.”*

The binding ruling will be binding for the tax authorities for a period of five years. However, it is possible for the tax authorities to shorten the period if required by the circumstances. The ruling is binding to the extent that the facts presented by the taxpayer upon submission of the request for the ruling do not differ from the actual facts of the transaction.



Binding rulings on the value of an asset transferred will no longer be binding if the value subsequently deviates significantly from the value set in the binding ruling. A significant deviation is at least DKK 1,000,000 (approximately €134,000 as of June 15, 2018) and at least 30%.

The assessment of whether the value of an asset has deviated from the time the binding ruling was issued may be based on either subsequent sale prices obtained by the buyer of the asset (via a direct or indirect sale), or the revenue subsequently generated by the asset. The binding ruling may be disregarded until the statute of limitations expires, and the tax authorities are allowed to take into consideration all activities that have taken place until this time. Binding rulings on the value of assets transferred are typically only relevant in transfer pricing cases. The statute of limitations for transfer pricing cases expires on May 1 of the sixth year following the relevant tax year, e.g., the value of an asset transfer taking place in the tax year 2018 can be set aside until May 1, 2024, taking into account any developments during this time.

The tax authorities are obliged not to set aside a binding ruling if the subsequent changes to the value of the assets are due to developments, market changes, and so on, that neither could nor should have been considered when the asset's value was originally determined.

# AUSTRIA

## Author

Niklas Schmidt

Wolf Theiss

Vienna, Austria

## INTRODUCTION

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, the following features of the Austrian tax system make Austria a jurisdiction worth considering for international holding companies:

- An international participation exemption for dividends and capital gains stemming from foreign subsidiaries
- No thin capitalization legislation
- An attractive corporate income tax rate of 25%
- No controlled foreign corporation legislation
- No withholding tax on interest paid to nonresidents
- No withholding tax on dividends paid to E.U.-resident parent companies
- An extensive network of tax treaties (more than 80)
- The possibility of obtaining advance tax rulings regarding reorganizations, group taxation, and transfer pricing issues
- A group taxation system that allows Austrian holding companies to deduct losses incurred by qualifying foreign subsidiaries
- Full deductibility of interest expense for loans in connection with the acquisition of subsidiaries

## 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.

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 25%.

## CORPORATE INCOME TAXATION

### **General**

A company is resident in Austria for tax purposes if it has its legal seat and/or its effective place of management in Austria. Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 25%.

Irrespective of taxable income, a minimum tax of 5% of the statutory minimum share capital is levied (*i.e.*, €1,750 for limited liability companies and €3,500 for stock companies). During the first ten years after incorporation of a limited liability company, a reduced minimum tax applies. It is €500 for the first five years and €1,000 for the following five years. Minimum tax payments made can be offset against future corporate income tax assessed without any limitations.

A nonresident company is a company having its legal seat and its effective place of management outside of Austria. A nonresident company is taxable on business profits to the extent it carries on a business through a permanent establishment 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.

### **Participation Exemption**

#### ***Participation Exemption for Dividends Received from Austrian Corporations and Portfolio Participations in Foreign Corporations***

Pursuant to §10/1 of the Austrian Corporate Income Taxation Act (“C.T.A.”), an exemption is provided for dividends (or similar distributions of profits) received by an Austrian company from (i) another Austrian company or cooperative, (ii) comparable entities resident in the E.U., or (iii) comparable entities resident in any other country with which Austria has concluded a comprehensive mutual administrative assistance treaty. Neither the extent of the holding nor the period during which the participation is held is taken into account in determining whether the exemption is applicable to a particular dividend.

The tax exemption for portfolio participations in foreign companies is not granted if (i) the foreign entity is not subject to a tax comparable to the Austrian corporation income tax, (ii) the tax rate is less than 15%, or (iii) the foreign entity is subject to a comprehensive set of tax exemptions. In these cases, the dividends paid are not tax exempt, but foreign tax paid is credited against Austrian tax. This is known as a switch-over from an exemption system to a credit system.

In comparison to dividends, capital gains from the sale of an Austrian domestic participation or a portfolio participation in a foreign corporation do not fall under the

participation exemption and are subject to tax at the standard rate of 25%. Gains realized upon the liquidation of the subsidiary are treated as capital gains and not as dividends, with the result that they are taxable.

A different set of exemption provisions applies to participations in non-Austrian companies that qualify as international participations. These are discussed in **Participation Exemption for Qualifying International Participations** below.

### Participation Exemption for Qualifying International Participations

#### General

According to §10/2 C.T.A., a qualifying international participation requires the following conditions to be met:

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

Dividends received from, and capital gains realized upon a sale of, a qualifying international participation held by an Austrian company are exempt from corporate income tax.<sup>1</sup> The exemption also applies to dividends paid out of profits earned by the foreign company prior to the acquisition of the shares by the Austrian holding company.

#### Capital Gains

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

The system of tax neutrality of capital gains, losses, and write-downs does not apply if the Austrian holding company elects otherwise. Such election must be made in the tax return filed for the business year in which the qualifying participation has been acquired. The option is irrevocable and extends automatically to any shares in the same company that the Austrian company may subsequently acquire.

Regarding a change in tax status due to a subsidiary’s transfer of domicile, the following provisions apply to outbound and inbound changes. Should a subsidiary become a qualified international participation through the transfer of the Austrian subsidiary’s seat to a foreign country, the difference between the book value of the participation and its higher going-concern value at the time of the transfer remains taxable in the case of a later sale of the participation. On the other hand, if a foreign

<sup>1</sup> C.T.A., §10/1, nr. 7.

*“Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of 25%.”*

subsidiary loses its status as a qualified international participation by virtue of the transfer of its seat to Austria (and no election for the taxability of the capital gains and losses has been made), the higher going-concern value at the time of the transfer is deemed to be the book value for the purpose of computing capital gains and losses.

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

### Anti-Avoidance Provisions

The tax exemption for qualifying international participations is not available if the following two conditions are fulfilled:

- The main business of the company consists of, directly or indirectly, deriving (i) interest income, (ii) rental income from movable tangible property (*i.e.*, rents from immovable property are not detrimental), or (iii) income from royalties or the alienation of participations (passive income). Dividend income derived, directly or indirectly, from an operating company is not considered passive income.
- The average rate of tax on the foreign company computed in accordance with the principles of Austrian tax law is below 15%. Foreign taxes that are indirectly imposed on the income of the foreign company are considered when calculating the foreign average tax rate. If the 15% threshold is missed only because the foreign tax law allows a deduction of depreciations on fixed assets or a deduction of loss carryforwards that are not deductible under Austrian law, the foreign corporate taxation is nevertheless deemed to be comparable to Austrian taxation.

In principle, the international participation exemption is denied only if adverse results are reached under both tests. However, if marginally favorable results are reached under one test, and adverse results are clearly reached under the other test, then the exemption will be denied.

If the participation exemption is denied, a switch-over to the credit method takes place, in which case:

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

prior to the Tax Cuts & Jobs Act (“T.C.J.A.”).<sup>2</sup>

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

In the event that the creditable tax is higher than the Austrian tax, the unused foreign tax credit can be carried forward and may be available as a credit against Austrian tax in following years.

The participation exemption may also be denied under the general anti-avoidance rule. Generally speaking, an abuse of law occurs when a specific legal structure can be explained only by an intent to avoid the payment of Austrian taxes. With regard to foreign subsidiaries of Austrian companies, the Austrian Supreme Administrative Court (*Verwaltungsgerichtshof*) frequently invokes this principle when it reaches the conclusion that a foreign subsidiary has no economic function whatsoever. In the case of an abuse of law, the foreign subsidiary may be treated as a transparent vehicle, with the result that its profits are directly taxed in the hands of the Austrian taxpayer.

### Treaty Exemptions

As set out above, the domestic participation exemption regime is in some respects more favorable than the international participation exemption. There is neither a minimum shareholding requirement nor a minimum holding period in the domestic regime. Under tax treaties that include an equal treatment clause, the Austrian company may enjoy the benefits of the international participation exemption for foreign companies resident in the jurisdiction of the treaty state, if the conditions for application of the domestic participation exemption are fulfilled. Such clauses appear in the double tax treaties with Ireland, Luxembourg, Sweden, and Turkey.

### Interest Deduction

As a general principle, costs relating to tax-exempt income are not tax deductible in Austria. However, interest payments connected with the financing of domestic or international shareholdings are deductible despite the fact that income derived from such participations is tax exempt. This rule does not apply to other financing costs, such as bank fees. A deduction is not granted for interest payments made in connection with financing for the purchase of intra-group participations. This limitation addresses perceived intra-group tax-avoidance structures.

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<sup>2</sup>

The T.C.J.A. eliminated the indirect foreign tax credit for direct investment dividends received by U.S. corporations. In its place, the T.C.J.A. adopted a dividends received deduction under Code §245A. Prior to the effective date of the T.C.J.A., Code §78 provided that the amount of an indirect foreign tax credit for the foreign income taxes imposed, *inter alia*, on the profits of first-tier foreign subsidiaries in which the U.S. corporation owned shares of stock representing at least 10% of the voting power were treated as additional dividend income for the U.S. corporation receiving dividends. This allows the foreign tax credit to be approximately the same whether a U.S. corporation operates abroad through a foreign branch or a foreign subsidiary.

## **Group Taxation**

Austrian tax law provides for group taxation. Consequently, the profits and losses derived by all members of a tax group are taxed at the level of the group parent. Group taxation may be elected independently for each potential group member.

The group parent must be (i) an Austrian company, (ii) an Austrian cooperative, or (iii) an Austrian branch of (a) an entity listed in Article 2 of the P.S.D., provided that it is legally comparable with an Austrian corporation, or (b) a company that is legally comparable to an Austrian corporation and has its seat and its effective place of management in a Member State of the E.E.A. Several companies may act jointly as group parent, provided that certain minimum holding requirements are met.

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

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

All profits and losses of the Austrian members of the group are calculated at the level of the group members, but are taxed at the level of the group parent. This treatment applies even in cases where a person who is not a group member holds a minority stake in one of the participating subsidiaries. For this reason, it is necessary that the group members agree on compensation payments. These agreements need not be annexed to the filing; it is sufficient that the group members confirm that such agreements exist. The compensation payments themselves will be tax neutral in Austria.

With regard to foreign group members, losses – but not profits – are taken into account. For the purpose of Austrian group taxation, the foreign loss is computed in accordance with Austrian tax law; however, the deductible foreign loss is limited by the amount calculated in accordance with the applicable foreign tax provisions.

The tax benefit in Austria for losses incurred by foreign group members must be recaptured in several cases. The first relates to dual loss benefits. When the foreign member can receive a credit in future years for the foreign loss against foreign profits in accordance with the rules of applicable foreign tax law – for example, by using a loss carryforward provision – recapture rules apply. As a result, if such losses can be used abroad, the tax base of the group parent will be increased by the amount of losses actually used abroad. The second relates to departures from the group. Should the foreign member cease to be a member of the tax group, the tax base in Austria will be increased in an amount corresponding to the losses previously utilized in Austria but not yet used against foreign profits.

If the foreign group member ceases to exist because of liquidation or insolvency and definite capital losses are incurred by the parent company, the recaptured amount is reduced by those write-downs that were not tax effective during the period of group



membership.

Foreign subsidiaries that are not resident in E.U. Member States can qualify as group members only if the country of residence has entered into an agreement on mutual administrative assistance in tax matters with Austria.

Finally, a write-down of participations in the share capital of group members is not deductible for tax purposes.

### **Disallowance of Interest and Royalty Payments**

Interest and royalty payments made by Austrian corporations to related parties are not tax deductible if, at the level of the receiving entity, such payments are tax exempt or taxed at a rate of less than 10% (also taking into account tax credits), or if, at the level of the beneficial owner, the receiving entity is not the beneficial owner of the interest or royalty payment.

## **WITHHOLDING TAX ON OUTBOUND PAYMENTS**

### **Dividends**

Dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 27.5%. However, dividends paid by an Austrian company to an E.U.-resident parent are exempt from taxation under legislation implementing the P.S.D. if the parent company directly holds a participation in the Austrian subsidiary of at least 10% for a minimum period of one year. If payments are made before the minimum holding period has elapsed, the payment is subject to withholding taxation; the parent company, however, is entitled to a refund once the minimum holding requirement has been met.

In addition, tax must be withheld in cases of suspected abuse according to §94, nr. 2 of the Austrian Income Tax Act (“I.T.A.”). In particular, abuse is assumed if the parent company is not 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.

Under most tax treaties, withholding tax is reduced to 15% for portfolio dividends and 5% for non-portfolio dividends. In some cases, withholding tax may be eliminated entirely. Austria has over 80 income tax treaties currently in effect, including those illustrated in the following table:

Albania	Algeria	Armenia	Australia
Azerbaijan	Bahrain	Barbados	Belarus
Belgium	Belize	Bosnia & Herzegovina	Brazil
Bulgaria	Canada	Chile	China
Croatia	Cuba	Cyprus	Czech Republic
Denmark	Egypt	Estonia	Faroe Islands
Finland	France	Georgia	Germany
Greece	Hong Kong	Hungary	Iceland
India	Indonesia	Iran	Ireland

*“Austrian tax law provides for group taxation. Consequently, the profits and losses derived by all members of a tax group are taxed at the level of the group parent.”*

Israel	Italy	Japan	Kazakhstan
Kuwait	Kyrgyzstan	Latvia	Liechtenstein
Lithuania	Luxembourg	Macedonia	Malaysia
Malta	Mexico	Moldova	Mongolia
Montenegro	Morocco	Nepal	Netherlands
New Zealand	Norway	Pakistan	Philippines
Poland	Portugal	Qatar	Romania
Russia	San Marino	Saudi Arabia	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Spain	Sweden	Switzerland
Taiwan	Tajikistan	Thailand	Tunisia
Turkey	Turkmenistan	Ukraine	United Arab Emirates
United Kingdom	United States	Uzbekistan	Venezuela
Vietnam			

### **Capital Gains**

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 for any time during the preceding five years. If the participation does not exceed this threshold, capital gains are not taxable. For corporate shareholders, corporate 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 has waived its right to tax capital gains from the disposal of shares under most of its tax treaties as specified in the O.E.C.D. Model Convention.<sup>3</sup> Only in case of so-called “property-rich” companies does Austria retain its right to tax.<sup>4</sup>

### **Royalties**

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%; expenses are not deductible (gross taxation). However, under most tax treaties, the withholding tax is reduced or eliminated. If the recipient of the royalties is resident in an E.U. or E.E.A. Member State, then expenses directly connected to the royalty income may be deducted from the withholding tax base (net taxation). However, in this case, an increased withholding tax rate of 25% applies.

Austria has adopted the E.U. Interest and Royalties Directive and exempts intra-group interest and royalty payments from withholding tax when the recipient is resident in an E.U. Member State. Section 99a of the I.T.A. applies to interest and royalty payments made to associated companies of a type listed in the Annex to the E.U. Interest and Royalties Directive or their permanent establishments located in an E.U. Member State. In all circumstances, the recipient must qualify as the beneficial owner of the payment.

<sup>3</sup> Paragraph 5 of Article 13 (Capital Gains) of the O.E.C.D. Model Tax Convention on Income and on Capital.

<sup>4</sup> *Id.*, ¶4.

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

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

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

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

*“Austria does not have controlled foreign corporation (‘C.F.C.’) legislation nor thin capitalization legislation.”*

### **Interest**

Interest payments to nonresident corporations are not subject to Austrian withholding tax.

Given the fact that Austrian tax law does not provide for statutory thin capitalization rules, debt financing has been an attractive method for repatriating profits from an Austrian holding company to its foreign parent company. However, in recent years the tax authorities have become more restrictive in this respect. In particular, in the case of shareholder loans, special attention is to be given to proper structuring: Under the general anti-avoidance rule, the interest accruing on the loan may be subject to withholding tax as a hidden distribution of profits if the terms of the loan do not meet the requirements of an arm’s length test.

### **Other Income**

A 20% withholding tax is levied on fees for technical and commercial consulting services rendered by a nonresident. However, where such services are provided without the use of a permanent establishment, Austria normally waives its taxing rights under 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.

### **Anti-Avoidance Legislation**

There are only a few specific statutory anti-avoidance provisions in Austrian tax law, the most noteworthy being the provisions relating to the international participation exemption. Austria does not have controlled foreign corporation (“C.F.C.”) legislation nor thin capitalization legislation. Transfer pricing issues are dealt with in accordance with general anti-avoidance principles, and in particular, the arm’s length principle.

However, there is a general anti-avoidance rule that provides for the principle of “substance over form.” As a consequence of austerity budgets and international B.E.P.S. measures, in recent years this provision has been applied by the Austrian tax authorities more often and to a wider scope of transactions. Thus, tax planning now yields results that are less predictable.

### **Foreign Tax Credit**

Pursuant to a decree issued by the Ministry of Finance, certain items of foreign-source income are exempt from Austrian taxation, including (i) income from immovable property located in a foreign state, (ii) business income attributable to a foreign permanent establishment, and (iii) income derived from building sites or construction or installation projects, if the following requirements are met:

- The Austrian taxpayer derives income from sources in a country with which Austria has not concluded a tax treaty.
- The foreign 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 foreign country in question. No “basket” rules exist for the foreign tax credit.

# FRANCE

**Author**  
Michel Collet  
*CMS-Francis Lefebvre*  
Paris, France

## CORPORATION INCOME TAX – GENERAL

The standard corporation income tax (“C.I.T.”) rate in France is 33.33%. However, a 3.3% additional social contribution may apply on the portion of the C.I.T. that exceeds €763,000. Stated differently, the additional social contribution applies when the taxable profits are greater than €2,289,000. The effective tax rate on the excess is 34.43%. Lower rates apply to small- and medium-sized enterprises (“S.M.E.’s”).

The standard C.I.T. rate will be reduced over time to 25% in accordance with the following schedule:

- In 2018, a rate of 28% will apply to taxable income not in excess of €500,000. Amounts in excess of €500,000 will be taxed at the rate of 33.33%.
- In 2019, a rate of 28% will apply to taxable income not in excess of €500,000. Amounts in excess of €500,000 will be taxed at the rate of 31%.
- In 2020, a single rate of 28% will apply.
- In 2021, a single rate of 26.5% will apply.
- In 2022, a single rate of 25% will apply.

The Finance Amendment Bill for 2017 introduced an “exceptional” tax targeting companies subject to C.I.T. with a turnover that exceeds certain thresholds.<sup>1</sup> Companies with a turnover exceeding €1 billion are subject to an additional 15% of the C.I.T. rate. This increases to 30% of the C.I.T. if the turnover exceeds €3 billion.

This new tax levied on large enterprises was designed to finance the 50% of refund that is available on the 3% distribution tax (see **The 3% Contribution on Distributions** below), which is often claimed by the same companies.

## NET OPERATING LOSSES

### **Carryforward**

Net operating losses (“N.O.L.’s”) can be carried forward with no time limit. However, the amount that is offset against the taxable result cannot exceed €1 billion plus 50% of the amount by which taxable income in the carryforward year exceeds €1 billion. Also, the transactions that give rise to the N.O.L. can be examined by the tax authorities in the carryforward year in which it is applied to reduced income.

<sup>1</sup> This applies to turnover on a stand-alone basis and/or aggregate turnover of tax-consolidated entities.

## **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 2018 can only be carried back to reduce taxable income in 2017. The carryback is capped at €1 billion. 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. (but not for the payment of the additional contributions to C.I.T.), or (iii) offered as a guaranty to a credit institution.

## **PARTICIPATION EXEMPTION OR DIVIDENDS RECEIVED DEDUCTION**

Dividend distributions received by French corporations, whether French or foreign-sourced, are in principle subject to C.I.T. For fiscal years closing as of December 31, 2015, the dividends received deduction (“D.R.D.”) regime has been amended to reflect the recommendations of the O.E.C.D.’s initiative to combat base erosion and profit shifting (the “B.E.P.S. Project”) and to comply with the E.U. Parent-Subsidiary Directive (“P.S.D.”).

Under the new D.R.D. regime, distributions are 95% exempt from C.I.T. where the following conditions are met:

- The shares are in registered form or deposited with an accredited institution.
- The receiving corporation holds at least 5% of the capital of the distributing company (“Qualifying Shareholding”) and is the effective beneficiary of the dividends.<sup>2</sup>
- The Qualifying Shareholding must be held for at least two years.

Specific rules apply for dividends distributed within corporations filing a consolidated tax return (see below **Tax Consolidation**).

The Qualifying Shareholding refers only to financial rights as they have recently been defined in French case law.<sup>3</sup> This proves flexible where companies issue preferred stock with increased financial rights and reduced voting rights.

The exemption applies from the first day of the Qualifying Shareholding, provided that the holding period is ultimately maintained for two years. Failure to maintain the shares for two years will result in a claw-back of the exemption. Late-payment interest along with the applicable C.I.T. must be paid within three months from the date of disposal of the shares that causes the termination of the Qualifying Shareholding. A disposal of shares within the course of a tax-free reorganization is disregarded for D.R.D. purposes.

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<sup>2</sup> In accordance with recent French case law, Article 145 1-b of the French tax code has been amended to include both full ownership and bare ownership as qualifying for the 5% capital threshold.

<sup>3</sup> C.E. November 5, 2014, decision no. 370650.

Only dividends attached to classes of stock with financial and voting rights are eligible for the 95% exemption. However, where the receiving entity maintains the Qualifying Shareholding for the two-year period, all the dividends received on all classes of shares benefit from the 95% exemption.

The D.R.D. regime applies to dividends and other distributions attached to the shares of stock held by the receiving corporation.

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. The disallowed amount is deemed to be the costs for management of the stock. N.O.L.'s can be applied against that taxable profit.

The D.R.D. applies to dividends received from foreign subsidiaries without limitation, other than those conditions set forth above. Subject to the application of tax treaties, foreign tax withheld in a source country may be used (no later than five fiscal years after the distribution) as a tax credit against any French withholding tax that may be due upon the further distribution of the dividend to a foreign shareholder of the French company.<sup>4</sup> Otherwise, tax withheld at the source is not recoverable. The 5% add-back is calculated on the gross amount of the dividends received from the foreign subsidiary.

Distributions from a company established in a non-cooperative country or territory (see **Non-Cooperative Countries and Territories and the Blacklist** below) are not eligible for the D.R.D., except where the corporate shareholder justifies that its holding is effective and not driven by tax fraud.

In anticipation of efforts to combat base erosion and hybrid instruments, the D.R.D. is not applicable to distributions that give rise to a 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, which requires the elimination of the exemption when the dividend is claimed as a deduction by the payor company.<sup>5</sup>

In addition, the exemption does not apply to dividends received when the ownership structure has not been chosen for a valid commercial purpose reflective of economic reality, so that its main purpose is obtaining the exemption. If proper justification cannot be shown, the ownership structure is not considered “genuine” for tax purposes and the application of the D.R.D. regime is denied.

The law does not outline the definitions of the terms “valid” commercial purpose and a “genuine” ownership structure. This could affect holding companies whose activities are strictly limited to the holding of securities, especially if their shareholders are residents of non-E.U. states. Case law that will develop over time should provide guidance regarding the circumstances in which the interposition of a holding company in an ownership structure will be considered unjustified.

This anti-abuse provision is aimed at artificial ownership structures with insufficient substance. The challenge for holding companies will be the addition of a new

<sup>4</sup> French Administrative Doctrine, BOI-RPPM-RCM-30-30-20-50, September 12, 2012.

<sup>5</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.

*“Dividend distributions received by French corporations, whether French or foreign-sourced, are in principle subject to C.I.T.”*

requirement to assess relevance within the holding chain in addition to relying on the number of employees or the size of the premises. The presence of an autonomous decision-making process at the level of the intermediate holding company is critical in asserting the validity of its commercial purpose. 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 apparent transfer of ownership. Through the trustee (“*fiduciaire*”), the settlor (“*constituant*”) should maintain all its voting and financial rights on the stock. This development allows the use of a *fiducie* for leveraged buyouts (“L.B.O.’s”) and proves more flexible and less burdensome than the so-called “double Luxco structure,” which is not exempt from tax or legal challenges.<sup>6</sup>

## TAX CONSOLIDATION

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 (either through other French consolidated companies or, subject to certain conditions, through an E.U.-resident company<sup>7</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 must be subject to French C.I.T. and have the same financial year.
- Another French company that is subject to C.I.T. must not hold 95% or more of the consolidating company, either directly or indirectly.<sup>8</sup>
- The parent company must satisfy the 95% minimum holding, directly or indirectly, throughout the entire financial year.
- Adequate tax group elections must be filed in a timely manner.<sup>9</sup>

The consolidating company is liable for C.I.T. on the group taxable income, which is the sum of all members’ profits and losses, subject to certain adjustments such as the elimination of intra-group transactions and distributions. Provided they are paid after the first consolidated fiscal year, intra-group distributions are neutralized. The 3% distribution tax does not apply within a consolidated context (see **The 3% Contribution on Distributions** below).

For dividend distributions among companies filing a consolidated return, the D.R.D. 5% add-back (see **Participation Exemption or Dividends Received Deduction** above) is reduced to 1%. These rules also are applicable to dividends received from

<sup>6</sup> Amending Finance Law for 2014, no. 2014-1655 of December 29, 2014.

<sup>7</sup> Or companies situated in Norway, Iceland, or Liechtenstein.

<sup>8</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>9</sup> The filing deadline matches the deadline for filing C.I.T. annual returns.

**“The Amended Finance Law for 2014 introduced new provisions allowing the tax consolidation of French sister companies and their subsidiaries.”**

subsidiaries in the E.U. or E.E.A. that would have been qualified to file a consolidated return had they been formed in France.<sup>10</sup>

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>11</sup>

Tax consolidation proves to be a powerful tool for L.B.O.’s since it combines consolidation and tax-free distributions (subject to the 1% add-back).

The French tax consolidation regime has been modified to reflect a favorable ruling in the *Papillon* case.<sup>12</sup> The 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. and (ii) subject to C.I.T. without exemption in its country of residence.

Pursuant to E.C.J. case law,<sup>13</sup> the Amended Finance Law for 2014 introduced new provisions allowing the tax consolidation of French sister companies and their subsidiaries (under the conditions explained above) where at least 95% is held, directly or indirectly, by the same E.U.-resident company<sup>14</sup> subject to C.I.T. in its country of residence. In such a case, one of the two top sister companies may elect to be treated as the consolidating company.

## NON-COOPERATIVE COUNTRIES AND TERRITORIES AND THE BLACKLIST

In order to bolster the fight against tax avoidance, the Finance Amendment Bill for 2009 established a blacklist of non-cooperative countries and territories (“N.C.C.T.’s”). A country or territory is defined as an N.C.C.T. if it meets the following criteria:

- It is not a Member State of the E.U.
- It has been reviewed and monitored by the O.E.C.D. global forum on transparency and exchange of information.
- It has not concluded 12 or more Tax Information and Exchange Agreements (“T.I.E.A.’s”).
- It has not signed a T.I.E.A. with France.

<sup>10</sup> *Groupe Steria SCA v. Ministère des Finances et des Comptes Publics*, Case C-386/14, [2015] E.C.R. I\_\_\_\_ (delivered September 2, 2015).

<sup>11</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>12</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>13</sup> *SCA Group Holding and Others*, Joined Cases C39-41-13, [2014] E.C.R. I\_\_\_\_ (delivered on June 12, 2014).

<sup>14</sup> Or in Norway, Iceland, or Liechtenstein.

The N.C.C.T. list may be updated annually, but as of June 2018, the list published on June 15, 2016 has not been changed: Botswana, Brunei, Guatemala, the Marshall Islands, Nauru, Niue, and Panama.

The N.C.C.T. list is subject to modification in accordance with developments concerning the conclusion of new tax treaties and/or the effectiveness of the exchange of information as provided by treaties and T.I.E.A.'s.

In cases where one of these countries is involved, French tax law provides for a significantly increased tax rate, tightened anti-abuse of law provisions, or exclusion from favorable tax regimes. In June 2015, the E.U. published its first list of international tax havens. The list comprises countries that are featured on the blacklists of at least ten Member States. It names 30 territories in total, including: Hong Kong and Brunei in Asia; Monaco, Andorra, and Guernsey in Europe; and a series of Caribbean jurisdictions, including the Cayman Islands and the British Virgin Islands.

Following the Panama Papers leaks, the European Commission announced its intent to reform the national tax blacklists of E.U. Member States by replacing them with a common E.U.-wide blacklist. Panama was also added to France's list of N.C.C.T.'s as a response to the leaks.

## THE 3% CONTRIBUTION ON DISTRIBUTIONS

Between August 17, 2012 and December 31, 2017, companies that were subject to C.I.T. were also subject to a contribution on the distributions made to their shareholders, whether French or foreign, equal to 3% of the distributed amount. This special contribution, treated as C.I.T. (and not as distribution tax), was not deductible.

S.M.E.'s or collective investment funds, and, under certain conditions, real estate investment trusts ("R.E.I.T.'s"), were not liable for the 3% contribution.

During the period in which it was in effect, the special contribution applied to dividends and distributions as defined by French tax law. This contribution was not applicable to dividends paid in shares (if the shares were not cancelled<sup>15</sup> within one year by the issuing company).

This contribution was not applicable within a tax consolidation context. Unused tax treaty foreign tax credits on inbound dividends could have been credited against the 3% contribution.

Since its enactment in French tax law, the 3% contribution was criticized as failing to conform with E.U. law. The tax applied to a French corporation that made distributions to an E.U. corporation that held 95% of its shares. If the 95% shareholder was a French corporation that headed a French consolidated group, an exemption applied to distributions within the group. The fact that the 3% contribution applied to subsidiaries and not to branches was also criticized as possibly constituting an infringement of the E.U. freedom of establishment. In February 2015, the E.U. Commission initiated an infringement procedure against France to address these issues.

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<sup>15</sup> Through a share buyback program not aimed at purging losses of the company (under §§L225-207 of the Commercial Code).

In 2016, the Constitutional Council determined that the exemption from the 3% sur-tax did not comply with the French Constitution because it violated the principle of equality. The difference in tax treatment could not be justified by sufficient factual or situational variances or by reason of the public interest. As a remedy, the exemption was applied to distributions made by French subsidiaries to their parent company on or after January 1, 2017, even if the parent company is resident outside the E.U. (under certain conditions), provided the 95% ownership requirement is met.

The Court of Justice of the European Union (“C.J.E.U.”) also addressed the 3% contribution. It determined that the 3% contribution did not comply with Article 4 of the P.S.D. in the case of the redistribution by a parent company of dividends received from E.U. subsidiaries. Claims may be brought to the French Tax Authorities (“F.T.A.”) to request reimbursement for payment of the 3% contribution if the E.U. corporate recipient of the distribution would have qualified to file a consolidated tax return had it been established in France (see **Tax Consolidation** above). The F.T.A. has begun to issue refunds.

Finally, in the Finance Amendment Bill for 2018 issued on September 27, 2017, just a few days before the French Constitutional Court issued its ruling, the French government decided to repeal the tax effective January 1, 2018.

## WITHHOLDING TAX ON OUTBOUND DIVIDENDS

Under §119 *bis* 2 of the F.T.C., a 30% withholding tax is levied on outbound dividend payments subject to tax treaties (see **Outbound Dividends and Tax Treaties** below). However, dividend payments made to N.C.C.T.’s are subject to a withholding tax of 75%.

In comparison, withholding is not required on dividends paid to qualifying E.U. parent companies subject to a 10% ownership test (the “E.U. Directive Exemption”) or, where the E.U. parent company is unable to recover French-source withholding tax, subject to a 5% ownership test (the “5% E.U. Exemption”). In both cases, a two-year holding requirement applies.

Also, under certain conditions, withholding tax is not due when distributions are paid to collective investment funds established in the E.U. or in a country with which France has signed a convention on administrative assistance (which is the case with a large number of countries).

### **Outbound Dividends Within the E.U.**

#### **E.U. Directive Exemption**

The E.U. Directive Exemption applies if the following tests are met:

- The distributing company is subject to C.I.T. (at the standard rate) in France without exemption.
- The shareholder corporation is an E.U. or E.E.A. resident defined as having its place of control and management in another E.U./E.E.A. Member State.
- The shareholder corporation is incorporated under one of the legal forms listed as an appendix to the E.U. Directive 2011/96/E.U. dated November 30, 2011.

- The shareholder corporation is the beneficial owner of the dividends distributed.
- The shareholder corporation is subject to C.I.T. in its E.U./E.E.A. Member State of establishment, without option and exemption.
- The shareholder corporation holds directly 10% or more of the capital of the distributing company.<sup>16</sup>

The dividend may be paid to an E.U./E.E.A. permanent establishment of an eligible shareholder corporation.

In order to comply with the provisions of the P.S.D., the exemption has been amended to reflect the E.U.-inspired anti-abuse provision already introduced for the French D.R.D. (see **Participation Exemption or Dividends Received Deduction** above). Thus, for fiscal years beginning on or after January 1, 2016, the E.U. Directive Exemption no longer applies to dividends received if the corporate shareholder cannot provide justification that the ownership structure was chosen for a “valid” commercial purpose and not with the primary aim of obtaining the exemption.

### 5% E.U. Exemption

The 5% E.U. Exemption that was provided for in the F.T.A. guidelines<sup>17</sup> published in the wake of the E.C.J. *Denkavit* decision<sup>18</sup> has entered into law.

The following requirements must be met:

- The shareholder must enjoy an exemption regime in its own country of residence. This is to say that the recipient shareholder must not be able to credit the French withholding tax against its own tax.
- The shareholder must be a resident of the E.U. or of Liechtenstein, Norway, or Iceland,<sup>19</sup> provided that the recipient shareholder’s country of residence has entered into a qualifying tax treaty with France.
- The parties must not have entered into an “artificial arrangement” for tax avoidance.
- The stock must (i) constitute 5% of the capital and voting rights of the distributing company, (ii) be in registered shares or be kept by a financial establishment, and (iii) be held for at least two years.

When the above conditions are met, the French withholding tax exemption automatically applies. In other words, if the qualifying shareholder is not taxed on the French-source dividends, as is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or greater interest in the French distributing company. If the dividend is taxed in the jurisdiction of residence of the E.U.

<sup>16</sup> As previously mentioned, the shares must be held for at least two years. However, the E.U. Directive Exemption can be claimed before the expiration of that period.

<sup>17</sup> BOI-RPPM-RCM-30-30-20-40, April 1, 2015.

<sup>18</sup> *Denkavit Internationaal BV and Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, Case C 170-05, [2006] E.C.R. I-11949.

<sup>19</sup> As members of the E.E.A.

shareholder, the dividend may still be paid gross if the E.U. qualifying corporate shareholder owns 10% or more of the French distributing company.

One may rely on tax treaty provisions as an alternative to the 5% E.U. Exemption. Several tax treaties provide for zero withholding tax on dividends, including those with Spain, Germany, Japan, and the U.S.

### **Outbound Dividends and Tax Treaties**

Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, ranging generally from 25% to 5%. In addition, some tax treaties provide for zero withholding tax on dividends (see above). Also, some income tax treaties have a narrow definition of dividends that restricts the application of the dividend provision only to distributions that qualify as a dividend under corporate law.<sup>20</sup> Consequently, distributions that are treated as dividends under tax law may not be covered by the “dividend” provision but, instead, for example, may fall under the “other income” provision, leading to a withholding tax exemption in France. An example is an exceptional distribution of reserves. Consequently, to the extent that the other operative provision in the tax treaty applies, withholding tax may not be due.

As of this writing, France has over 120 tax treaties currently in force, including the jurisdictions listed below:



Albania	Algeria	Andorra	Argentina
Armenia	Australia	Austria	Azerbaijan
Bahrain	Bangladesh	Belarus	Belgium
Benin	Bolivia	Bosnia & Herzegovina	Botswana
Brazil	Bulgaria	Burkina Faso	Cameroon
Canada	Central African Republic	Chile	China
Congo (Rep.)	Croatia	Cyprus	Czech Republic
Ecuador	Egypt	Estonia	Ethiopia
Finland	French Polynesia	Gabon	Georgia
Germany	Ghana	Greece	Guinea
Hong Kong	Hungary	Iceland	India
Indonesia	Iran	Ireland	Israel
Italy	Ivory Coast	Jamaica	Japan
Jordan	Kazakhstan	Kenya	Kosovo
Kuwait	Latvia	Lebanon	Libya
Lithuania	Luxembourg	Macedonia	Madagascar
Malawi	Malaysia	Mali	Malta
Mauritania	Mauritius	Mexico	Moldova
Monaco	Mongolia	Montenegro	Morocco
Namibia	Netherlands	New Caledonia	New Zealand
Niger	Nigeria	Norway	Oman

<sup>20</sup> CE October 13, 1999, *SA Banque Francaise de l’Orient*, RJF 12/99 #1587.

Pakistan	Panama	Philippines	Poland
Portugal	Qatar	Québec	Romania
Russia	Saudi Arabia	Senegal	Serbia
Singapore	Slovakia	Slovenia	South Africa
South Korea	Spain	Sri Lanka	St. Martin
St. Pierre & Miquelon	Sweden	Switzerland	Syria
Taiwan	Thailand	Togo	Trinidad & Tobago
Tunisia	Turkey	Turkmenistan	Ukraine
United Arab Emirates	United Kingdom	United States	Uzbekistan
Venezuela	Vietnam	Zambia	Zimbabwe

France signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting on July 6, 2017. The French position covers 88 of the French double tax treaties and includes several reservations.

## CAPITAL GAINS TAX ON SHAREHOLDINGS – EXEMPTION

Gains on the sale of substantial shareholdings (“participations”) are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for capital gains tax (“C.G.T.”) relief. Such relief is available in the form of an exemption or a reduced C.I.T. rate.

C.G.T. on substantial shareholdings covers gains on the disposal of participations, including shares or interests that the shareholder intends to hold as long-term investments, *viz.*, at least two years. They must be sufficient to provide the shareholder with control of, or significant influence over, the company; these tests are regarded as met with a 10% or greater interest. Stock eligible for the D.R.D. (5% interest) and stock received within the course of a public offering are also eligible. Shareholdings in N.C.C.T.-resident entities cannot qualify.

The exemption applies subject to a 12% add-back, which brings the effective tax rate to 4.13% of the gain, unless N.O.L.’s are available.<sup>21</sup> The 12% costs and charges share is calculated from the amount of exempted gross capital gains (capital losses are not taken into account). Disposals of shares in a listed real estate holding company (“S.I.I.C.,” which is the French equivalent of a R.E.I.T.), of which more than 50% of the French assets consist of real estate, are eligible for the application of a 19% reduced C.I.T. rate, *i.e.*, a 19.62% effective tax rate, if the substantial shareholding requirements are met.<sup>22</sup> Disposal of shares of non-listed real estate holding companies are subject to the standard C.I.T. rate.

Capital gains resulting from the disposal of interests in venture capital funds or companies (“F.C.P.R.” or “S.C.R.”) that are held for at least five years are eligible for the C.G.T. exemption, but only in proportion to the investments made by the company and funds in qualifying substantial participations; otherwise, a 15% reduced C.I.T.

<sup>21</sup> Based on a 33.33% standard C.I.T. rate increased by the 3.3% surcharge mentioned under **Corporation Income Tax – General** above.

<sup>22</sup> This consists of the 19% tax rate increased by the 3.3% surcharge mentioned under **Corporation Income Tax – General** above.

*“Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, ranging generally from 25% to 5%.”*

“France has unilaterally introduced an anti-hybrid mechanism.”

rate applies (*i.e.*, a 15.45% effective tax rate).

Deductions for short-term capital losses incurred upon the transfer of shares held for less than two years to a related party are deferred until the shares are effectively transferred to a non-related party.

## OTHER TAX ITEMS

### Deductibility of Interest Charges

Interest paid on a debt-financed acquisition of shares is deductible, even if the shareholder qualifies for a participation exemption on dividends (see **The 3% Contribution on Distributions** above) and C.G.T. relief (see **Withholding Tax on Outbound Dividends** above). This is, however, subject to several interest deductibility limitations.

Also, within a tax-grouping context, an anti-debt-push-down mechanism restricts the deductibility of interest. (See the Charasse Amendment discussed in **Tax Consolidation** above.)

### Interest Rate Test

Only interest paid at an arm's length rate can be considered tax deductible. When paid to an affiliate, interest expense 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.*, 1.67% for financial years ending on December 31, 2017). Interest expense paid in excess of this limit is deductible only to the extent that the company establishes that they is arm's length. However, these provisions are not applicable to interest paid to shareholders that qualify for the participation exemption regime on dividends (see **The 3% Contribution on Distributions** above).

Excess interest paid to affiliates under the interest rate test is treated as a distribution eligible for the participation exemption regime on dividends, or it may be subject to withholding tax (pursuant to the terms of specific tax treaties) with resident lender affiliates. Some tax treaties may deny France the right to tax a deemed distribution where the dividend provision of the tax treaty does not encompass deemed distributions (see, *e.g.*, Luxembourg and the Netherlands).

### Anti-Hybrid Rule

In an effort to curb the use of hybrid instruments, France has unilaterally introduced an anti-hybrid mechanism. This mechanism disallows interest deductibility in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax that would have been due in France (*i.e.*, at least 8.33% according to the French Parliament, which corresponds to one-quarter of the 33.33% French C.I.T. standard rate<sup>23</sup>). The rate should refer only to the tax regime applicable to the gross income received from France, as opposed to the effective tax rate of the recipient entity. Consequently, expenses

<sup>23</sup>

Under F.T.A. guidelines, the reference tax rate should account for additional contributions to C.I.T. to which the foreign company would have been subject if resident of France (BOI-IS-BASE-35-50, August 5, 2014).

and losses that reduce the taxable result of the foreign company are not considered if the corresponding income is taxable at a rate of at least 8.33%. The guidelines do not provide for a case in which the recipient entity is itself indebted and serves a debt. The French general anti-avoidance rule should also be considered.

### Thin Capitalization

Related-party debt within the scope of French interest limitation rules includes debt extended by the controlling shareholder (whether direct or indirect) and sister companies that are under control of the same shareholder (“Affiliates”). A shareholder directly or indirectly holding at least 50% of the capital of the French indebted company, or exercising control over the indebted company’s decisions, is regarded as controlling the company for purposes of the thin capitalization rules. Third-party debts that are guaranteed by related parties are assimilated to related-party debt for thin capitalization purposes. However, this extended scope does not apply to debts related to

- bonds offered to the public;
- loans secured by a pledge, if the pledge is (i) over the shares of the borrower (e.g., a parent company gives a pledge on shares of a French subsidiary to guarantee the loan granted by a bank to the subsidiary), (ii) on receivables held by the parent company on its direct subsidiary, or (iii) over securities of a direct or indirect shareholder of the borrowing entity, provided that the entity that grants the pledge and the borrower are members of the same French tax-consolidated group;
- refinancing resulting from the mandatory repayment of pre-existing debt after a change of control of the borrower; or
- loans contracted prior to January 1, 2011, for the purpose of an acquisition of securities, or refinancing contracted prior to January 1, 2011 for loans granted for the purpose of an acquisition of securities.

The test applies to Affiliates only. Two companies are regarded as Affiliates where (i) one holds directly or indirectly a majority in the capital of the other (legal control) or *de facto* controls it, or (ii) both companies are, within the same criteria, under the *de facto* or legal control of a third company.

It is then applied to the allowed portion of the interest under the interest limitation rules explained above to determine if the interest expense is actually deductible.

Deductions claimed for interest expense will be disallowed when the creditor is an Affiliate and the following three tests are met:

- The related-party debt exceeds 1.5 times the amount of the net equity (taking into account related-party debt only).
- 25% of the operating profit before tax, related-party interest expense, depreciation, amortization, and certain specific lease payments is less than the actual related-party interest.
- The interest paid to related parties exceeds the interest received from related parties.

***“Mandatory filing requirements aim to provide tax authorities with an overview of the states where expenses, income, and profits are located, and are likely to support future reassessments.”***

The disallowed interest is equal to the highest of the above limitations. If it is less than €150,000 or if the disallowed interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group, the interest is allowed.

The disallowed interest can be carried forward to offset profits in the following years (up to 25% of the profits before tax, after the deduction of currently allowed related-party interest). The carryover is reduced by 5% each year from the second carryover year on.

The rules provide for two safe harbors:

- First, a 1.5-to-1 debt-to-equity ratio safe harbor is applicable, as seen above.
- Second, a worldwide group safe harbor applies.

Under the worldwide group safe harbor, the interest expense deduction will not be limited if the French borrower demonstrates that the disqualified interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group. Related-party debt and reciprocal transactions within the worldwide group should be set aside when computing the debt-to-equity ratio of the worldwide group. The worldwide leverage safe harbor does not allow for the leverage test to be divided by industry within the worldwide group, even though the degree of leverage generally differs from one industry to the next.

Interest exceeding the higher of the above limits is not tax deductible but may be carried forward within certain limits (they are deductible within the limit of 25% of the current income before taxation). Further, the interest deduction is reduced by 5% annually from the second year of the carryforward period. The excess interest is not regarded as a deemed distribution. No withholding tax should apply, especially where the recipient is treaty protected.

Among companies filing a consolidated tax return, the thin capitalization rules are applied at the level of each member on a stand-alone basis. The aggregate of disallowed interest may be deducted from the consolidated tax profit for an amount that does not exceed the difference between (i) the aggregate of the related-party interest paid by companies filing a consolidated tax return to non-consolidated entities and carryovers of pre-consolidation disallowed interest that was deducted during the consolidation, and (ii) 25% of the operating profits of member companies before tax.

Banks and certain financial institutions are excluded from the scope of the new thin capitalization rules. In addition, related-party debts incurred within the course of cash-pooling arrangements or asset-financing transactions involving leases or “credit bail” contracts may not be considered for computation purposes, for the purpose of those activities only.

### **M&A Context Limitation**

As part of the 4th Finance Amendment Bill for 2011, an anti-abuse rule was introduced under §209 IX F.T.C., whereby interest charges incurred in connection with the acquisition of substantial shareholdings in a French subsidiary may be disallowed unless the French acquiring company (or a French permanent establishment of a foreign company) justifies that the following cumulative conditions are met:

- “Decisions related” to the stock of the newly acquired French company are effectively taken in France, by the acquiring company itself or by a parent or a sister company established in France only.
- Where the French acquiring company actually exercises “control or influence,” it is effectively exercised in France by the same entities.

The two conditions above must be met either with respect to the shareholding acquisition fiscal year or with respect to the fiscal years relating to the 12-month period following the shareholding acquisition. If the company is not in a position to perform the required demonstration, interest expense on funds borrowed to make the acquisition are not deductible until the end of the eighth year following the shareholding acquisition.

This legislation aims to prevent foreign-based groups from using a French holding company to take advantage of the French consolidation regime in claiming a deduction of the interest on the acquisition debt against profits of the French targets. Originally, the bill was aimed only at French targets, but for anti-discrimination purposes, the scope was expanded to include non-French targets.

The safe harbor for decision-making processes within French-only parents or Affiliates proves discriminatory *vis-à-vis* foreign-based groups and may be challenged under E.U. law (on the claim that it is an obstacle to the freedom of establishment) and treaty law (where the treaty includes an article preventing discrimination towards subsidiaries of parent companies established in the country of the treaty partner, comparable with Article 24.5 of the O.E.C.D. Model Tax Treaty).

The limitation does not apply where (i) the fair market value of the acquired shares does not exceed €1 million; (ii) the acquisition is not financed, directly or indirectly, through debt; or (iii) the consolidated debt-to-equity ratio of the group is greater than or equal to the debt-to-equity ratio of the French acquiring company.

The Finance Amendment Bill for 2018 introduced new provisions stating that for the purposes of the limitation, a foreign company will be treated in the same manner as a French company if it is incorporated in an E.U. Member State or E.E.A. Country that has signed a tax convention on administrative assistance with France. In other words, the limitation is no longer applicable in cases where the E.U. or E.E.A. company exercises control or influence over, and makes the decisions related to, an acquired French company.

#### General Limitation on Interest Deductibility / Tax Barrier

Only 75% of net financial expenses are deductible if the amount exceeds €3 million. Where the amount of tax-deductible financial expenses (after the application of the interest tax deductibility limitation rules described above) less the amount of the financial profits received equals €3 million or more, 25% of the net amount is not tax deductible. The limitation also applies to third-party debt.

#### **Withholding Tax on Interest – Exemptions**

According to §119 *bis* 1 and 125 A III of the F.T.C., a withholding tax is imposed on interest paid to a nonresident recipient. However, French domestic tax law provides for several exemptions, resulting in the almost systematic exemption of withholding tax. Three of these exemptions are outlined below, for (i) interest on loans, (ii)

interest on bonds, and (iii) interest paid inside the E.U.

In addition, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company. Accordingly, each of the income tax treaties between France and Germany, Austria, the U.K., Ireland, and Sweden provides for zero withholding tax on interest.

### Interest on Loans

For loans contracted on or after March 1, 2010, no withholding tax applies to interest paid by a French company to a nonresident company. This exemption does not apply to interest paid to an N.C.C.T. Instead, a 75% withholding tax is still applicable where the interest is paid on an account held in an N.C.C.T. (see **Participation Exemption or Dividends Received Deduction** above), unless the debtor justifies that the operations that gave rise to the interest do not principally aim or result in shifting profits to the N.C.C.T.

For loans contracted before March 1, 2010, interest can be paid free of withholding tax where

- the initial lender is a nonresident individual or legal entity established outside of France;
- the loan is documented by an agreement executed before the loan proceeds are transferred to the French company; and
- the loan agreement sets forth the principal, the date of repayment, the interest rate, and any additional remuneration to the lender.

The subsequent sale or assignment of the receivable should not jeopardize the application of the exemption.

### Interest on Bonds

Under §119 *bis* 1 of the F.T.C., interest paid to nonresidents on bonds from French issuers is exempt from withholding tax provided that the securities were issued after January 1, 1987. Under §125 A III of the F.T.C., the levy at source is not applicable to interest on bonds (“obligations”) issued after October 1, 1984 that are paid by a debtor domiciled or established in France, if the beneficial owner of the interest demonstrates that he or she has a fiscal domicile or corporate seat outside the territory of the French Republic, Monaco, or a member state of the so-called “*Zone Franc*.” Evidence of the foreign domicile or seat of the beneficial owner must be furnished to the paying agent of the interest. Evidence of the foreign domicile is assumed for bonds converted into euros on or after January 1, 1999. The exemption applies to tradable securities and units in French securitization vehicles (“*fonds commun de créances*”).

### Interest Paid to a Related E.U. Company

The recipient is an eligible E.U. company that is subject to C.I.T. in its jurisdiction of residence. The “payer” and the “beneficial owner” must be related parties. Parties will be treated as related where (i) the payer or the beneficial owner directly owns at least 25% of the capital of the other party, or (ii) a third E.U. company directly holds at least 25% of the capital of both the payer and the beneficial owner. The

ownership interest must be held for at least two years. Payments made before the expiration of the two-year period can be exempted from withholding tax if the shareholder undertakes to hold the ownership interest for at least two years. An E.U. permanent establishment of an eligible E.U. company can be treated as an eligible party (either as the payer or beneficial owner) as long as the interest is subject to C.I.T. in the E.U. Member State of the permanent establishment. The beneficial owner of the payments must give the payer all required evidence that the tests have been fulfilled.

The exemption includes an anti-abuse provision under which the exemption may be denied where the beneficial owner is controlled directly or indirectly by a non-E.U. corporate shareholder and obtaining the tax benefit is a principal reason for the structure. (See **E.U. Directive Exemption** above, for E.U. dividends.) A decree should clarify the situations covered by the anti-abuse rule. However, where an income tax treaty entered into by France with the jurisdiction of residence of the controlling shareholder provides for a zero rate of withholding tax on interest, the anti-abuse provision may be of little practical importance. The U.S. is one such example.

### **C.F.C. Legislation**

Section 209 B is the French counterpart to “Subpart F” of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d’Etat*, struck down §209 B as discriminatory under the French-Swiss Tax Treaty.<sup>24</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 controlled foreign corporation (“C.F.C.”) rules were therefore revisited and reformed.



The law changed effective January 1, 2006. The C.F.C. rules apply both to foreign enterprises (namely permanent establishments) and to foreign entities. The foreign entities should be “established or formed” in a foreign country. They include legal entities whether or not they are distinct from their shareholders (*viz.*, companies, partnerships, associations, etc.). They also include trusts.

The holding threshold increased from 10% to “more than 50%” for the foreign entity to be treated as a C.F.C. under §209 B. However, that threshold drops to 5% if 50% of the legal entity is held directly or indirectly by other “French enterprises” that control or are under the control of the first French company.<sup>25</sup> In the case of related enterprises, the 5% test applies even if the related enterprise is not established in France.

<sup>24</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>25</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.

The new provisions do not replace the current anti-abuse provision, pursuant to which an interest held by “sister entities” (whether French or foreign) is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is subject to C.I.T. at a rate below 16.66% (*i.e.*, 50% of the French C.I.T.).

Section 209 B provides an E.U. exclusion. The C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a “wholly artificial arrangement, set up to circumvent France tax legislation.” This provision follows the case law developed by the E.C.J., particularly *Cadbury Schweppes*.<sup>26</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 (offices, etc.) and that the subjective intent of the establishment (*i.e.*, as tax planning) was not material.

A second exclusion (the “Trade or Business Exclusion”) may apply to C.F.C.’s established in non-E.U. countries.

Where a C.F.C. derives passive income from financial activities or the management of intangibles, the exclusion applies unless (i) the passive income comprises more than 20% of the profits of the C.F.C., or (ii) more than 50% of the profits of the C.F.C. are derived from financial activities, the management of intangibles, and services rendered to affiliates. In such a case, the French taxpayer must demonstrate that using the foreign entity or enterprise does not primarily result in locating profits in a low-tax jurisdiction.

As of March 1, 2010, for C.F.C.’s established in an N.C.C.T., the trade and business exclusion does not apply unless the taxpayer can justify the effectiveness of the business carried out and comply with the 20% and 50% ratios.

If the C.F.C. does not qualify for either the E.U. or the Trade or Business Exclusions, the French taxpayer may still prove that the establishment of the C.F.C. does not primarily result in relocating profits to low-tax jurisdictions to avoid the taxation of the C.F.C.’s profits in France.

In response to a 2002 decision by the *Conseil d’Etat*, a new law provides that profits derived from the legal entity established or formed abroad and attributed to the French company under §209 B would be treated as “deemed distributions.” The F.T.A. contends that under these conditions, conflict with the tax treaties would be eliminated.

N.O.L.’s of the French company are available to reduce the taxable income arising from the attribution of profits from a C.F.C. Moreover, tax credits of the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

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<sup>26</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).

## **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 the following taxpayers:

- 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 – corresponding to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European Commission – must include (i) general information about the group and its subsidiaries, known as the “master file,” and (ii) detailed information on the French audited company (*i.e.*, a description of its activities and transactions, including a presentation of the applied transfer pricing method), known as the “country-specific file.” This documentation must be presented to the F.T.A. when the company is audited.

If the company fails to provide the documentation, a fine amounting to the greater of €10,000 or 5% of the adjusted profits<sup>27</sup> may apply. For tax audits realized on or after January 1, 2015, the fine may be as much as 0.5% of the amount of the transactions for which no documentation has been presented.

Since 2014, the following entities must also annually electronically file a simplified transfer pricing form within the six-month period following the filing of their tax return:

- French companies with a gross annual turnover or gross assets equal to or exceeding €50 million
- French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €50 million threshold
- French parent companies that directly or indirectly own at least 50% of companies meeting the €50 million threshold
- Worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €50 million criteria within the perimeter)

Where transactions carried over from affiliated companies involve an amount below €100,000 per type of transaction, the company does not have to file the simplified

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<sup>27</sup> The actual rate will depend on the behavior of the company.

transfer pricing documentation.

The law does not provide a specific penalty for the failure to file. Therefore, the general penalty of €150 per document provided by Article 1729 B of the F.T.C. should apply for each document that is not filed. In cases where some items are missing or inaccurate in a document, the penalty is equal to €15 per item with a minimum penalty of €60.

For companies not subject to the mandatory transfer pricing documentation, the F.T.A. may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company, and details regarding the activities of the nonresident affiliated companies and the tax regime applicable to them.

In order to avoid uncertainty, taxpayers may want to reach an advance transfer pricing agreement with the F.T.A. The advance pricing agreement could be unilateral, bilateral, or multilateral. The French program proves to be efficient and pragmatic. Finally, in accordance with the O.E.C.D.'s B.E.P.S. Action Plan, the Finance Bill for 2016 introduced CbC Reporting obligations for French companies that (i) control foreign subsidiaries or have permanent establishments overseas, and (ii) have a consolidated turnover exceeding €750 million.

This disclosure obligation concerns

- the activities and places of activity of the entities in the group, and
- information about profit splitting among these entities.

According to Article 223 *quinquies* C of the F.T.C., this new measure also applies to international groups that meet the turnover threshold and have either a French permanent establishment or a French subsidiary, unless they are subject to a similar obligation in their respective country of residence. French entities that are held by foreign companies subject to a similar obligation in their respective country of residence are not subject to CbC Reporting in France.

These mandatory filing requirements aim to provide tax authorities with an overview of the states where expenses, income, and profits are located, and are likely to support future reassessments.

The reporting obligations must be fulfilled within 12 months after the closure of the annual accounts.

The new CbC Reporting obligations apply to fiscal years beginning on or after January 1, 2016. Failure to comply with the requirements will trigger the imposition of a penalty which cannot exceed €100,000 per default.

A European directive<sup>28</sup> provides for a similar mechanism at the E.U. level. Under the directive, the mandatory exchange of information between the European tax administrations is extended to include the automatic exchange of information on the CbC Report.

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<sup>28</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.



## **Financial Transaction Tax**

Introduced by former French President Nicolas Sarkozy as a push toward an E.U.-wide tax, the Financial Transaction Tax (“F.T.T.”) imposes participation by the financial industry in the restoration of public accounts. This 0.1% tax applies to acquisitions of listed stock issued by companies whose legal seat is in France with a market capitalization above €1 billion on January 1 of the year during which the acquisition takes place.<sup>29</sup>

Taxable transactions involve French-issued equity securities, as defined above, and securities that may give rise to equity rights (for example, preferred stocks, convertible bonds, and any other bonds that may give rise to equity rights).

Acquisitions of options and futures are not taxable. With tax being due at the time the stock is delivered at maturity (if not issued by the company), double taxation may arise.

The F.T.T. also applies to instruments equivalent to French-listed stock or stock rights even if issued by another issuer under a foreign law (e.g., American depositary receipts).

The term “acquisition” includes a transfer of ownership through a purchase, exchange, contribution, or exercise of an option or through a futures contract.

To be subject to the F.T.T., the stock or equivalent instruments would be negotiable on a regulated market in France, the E.E.A., or on some limited non-E.U. regulated markets, such as in Switzerland (Bourse Suisse) and Montréal (Bourse de Montréal Inc.). The N.Y.S.E. is not included. Stocks listed on a multilateral trading system are also outside the scope of the tax.

After ten Member States including France, Belgium, and Germany implemented an F.T.T., the question arose as to whether an E.U.-wide F.T.T. would be implemented. A growing number of Member States are resisting the proposal over concerns regarding competitiveness. The project is controversial, especially in the context of Brexit, since the U.K. is one of its major opponents.

## **Transfer Taxes**

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares, the following rates generally apply:

- As of August 1, 2012, a fixed tax rate of 0.1% applies to transfers of stocks issued by a French S.A., S.C.A. or S.A.S. – except if the entities qualify as real estate holding companies for tax purposes (intra-group transactions can benefit from a transfer tax exemption).
- Transfers of units issued by French partnerships, the capital of which is not divided into stocks – except if the entities qualify as real estate holding companies for tax purposes – are subject to a fixed transfer tax rate of 3%. A relief equal to €23,000 divided by the total number of units issued by the entity is applied to the taxable value of each unit.

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<sup>29</sup> This could affect about 100 French companies.

**“The Financial Transaction Tax (‘F.T.T.’) imposes participation by the financial industry in the restoration of public accounts.”**

- 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>30</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 fraction of the transfer price below €23,000, (ii) 3% for the fraction between €23,000 and €200,000, and (iii) 5% for the fraction exceeding €200,000.

### **Disclosure Obligations and Penalties Applicable to Advisors**

A bill brought before French Parliament on March 28, 2018, that is currently under discussion provides for a fine applicable to advisors who assist taxpayers with transactions that are considered to be tax fraud or abuse of law by the F.T.A. The proposed fine is 50% of the advisor’s fees, with a minimum penalty of €10,000.

In addition, E.U. Directive 2018/822<sup>31</sup> dated May 25, 2018, created an obligation for intermediaries to report certain potentially aggressive cross-border tax planning arrangements to the F.T.A. within 30 days of implementation. Reportable cross-border arrangements contain at least one of the hallmarks listed in the Directive as indicative of a potential risk of tax avoidance. If an intermediary is unable to submit a report due to a legal professional privilege, the obligation to disclose falls on the taxpayer. Advisors shall inform clients involved in a reportable transaction of their obligation to disclose.

Arrangements implemented between June 25, 2018 and July 1, 2020 must be reported by August 31, 2020. E.U. Member States must exchange information by October 31, 2020.

### **B.E.P.S. and France**

France is one of the founding members of the O.E.C.D. and is highly involved in the O.E.C.D.’s work relating to the B.E.P.S. Project. Soon after the publication of the O.E.C.D. report, “Addressing Base Erosion and Profit Shifting,” in February 2013, the Parliament Commission of Finances released a report on the same topic, which reaffirmed the prevention of tax evasion and tax fraud as a priority for the French

<sup>30</sup> The tax rate applicable depends from the location of the asset.

<sup>31</sup> Council Directive 2018/822/E.U. of May 25, 2018 amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2018 O.J. L 139/1.

government and formally endorsed the B.E.P.S. Project. The French government itself also actively encourages the E.U. to act on these issues.

A report relating to the taxation of the digital economy, ordered by the French Ministry of Economy and Finance, was published in January 2013. In a related press release, the French government stated its intention to take more decisive action in the G-20, the O.E.C.D., and the E.U., in order to adapt international tax rules to the reality of the digital economy and, in particular, to seek a more efficient definition of “permanent establishment.” The report especially raised the possibility of tax on the digital economy in relation to personal data. The French government hopes that this proposition will be further analyzed.

In particular, the French government places high priority on the elimination of inappropriate double nontaxation, the reinforcement and effectiveness of anti-avoidance rules, and addressing profit shifting issues that arises in the context of the digital economy. B.E.P.S. issues are regularly debated in commissions and assemblies of French Parliament, and several legal provisions have been introduced in recent finance bills. For example, the 2013 to 2016 finance bills have included provisions relating to the following:

- The obligation of tax professionals to disclose tax optimization schemes to the F.T.A.
- The modification of the abuse-of-law provisions from an *exclusively* tax-driven test to a *principally* tax-driven test
- The application of a penalty for tax professionals who advise the use of abusive tax schemes
- The limitation of the D.R.D. regime (see **Participation Exemption or Dividends Received Deduction** above) to dividends issued from profits resulting only from activities subject to C.I.T.

The French Constitutional Court dismissed these provisions, as they do not in conform with the French Constitution on various grounds. However, other provisions have been successfully enacted:

- The limitation of the D.R.D. regime so that it excludes dividends that have been deducted when determining the distributing company’s taxable income,<sup>32</sup> or when the ownership structure cannot be considered genuine because it is not justified by a valid commercial reason (see **Participation Exemption or Dividends Received Deduction** above)
- The anti-hybrid mechanism, which disallows interest in cases where it cannot be proven that the interest is actually subject to tax in the hands of the recipient at a rate equal to at least one-quarter of the tax which would have been due in France (see **Deductibility of Interest Charges**)
- The annual CbC Reporting requirements for French companies controlling foreign entities or having permanent establishments overseas (see **Transfer Pricing**)

Certainly, the French government is highly involved in the B.E.P.S. Project at the

<sup>32</sup> Transposition of Council Directive 2014/86/E.U. of July 8, 2014, *supra* note 5.

“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.”

level of the O.E.C.D., as well as at the level of the E.U., and it is expected to be a pioneer in implementing new regulations that may be proposed to combat B.E.P.S. within either organization, or at a federal level.

On the ground, experience shows that tax auditors do not hesitate to retain positions inspired by the current work of the O.E.C.D. on B.E.P.S., even if it is not compliant with the current tax law. Consequently, it appears that France has already started the process of adopting some anti-B.E.P.S. measures unilaterally. Such action gives rise to questions of potential double taxation unless a multilateral policy is adopted.

In any case, implementation of the B.E.P.S. Action Plan continues within the E.U. Member States. Additionally, a project known as the Anti-Tax Avoidance Directive (“A.T.A.D.”), directly inspired by the B.E.P.S. Project, is currently being discussed by the Council of the European Union.

On July 12, 2016, the European Council adopted the A.T.A.D., which builds on the principle that tax should be paid where profits are made. It includes legally-binding measures to block the methods most commonly used by companies to avoid paying tax. It also proposes common definitions of terms such as permanent establishment, tax havens, transfer prices, royalty costs, patent boxes, and letterbox companies. The main measures relate to the following:

- A general interest limitation rule restricting the tax deductibility of net borrowing costs (all deductible borrowing costs minus taxable financial incomes) to 20% of the taxpayer’s E.B.I.T.D.A.
- An anti-hybrid general rule denying the tax deductibility of an expense in the state of the beneficiary when it is also considered a tax-deductible expense in the source state
- A “switch-over” clause substituting a tax credit for low-taxed foreign incomes (less than 15%) in place of an exemption
- An exit tax for the transfer of assets under certain conditions
- A C.F.C. rule where passive income or income derived from “non-genuine arrangements implemented for a tax purpose” received by permanent establishments and foreign subsidiaries located in a low-tax jurisdiction would be included in the taxable basis of the parent company

The A.T.A.D. obliges E.U. Member States to conform their domestic legislation with its provisions by December 31, 2018 at the latest. This reality may trigger difficulties for certain countries, France included, which have already implemented comparable but not totally similar anti-abuse provisions regarding, *inter alia*, C.F.C. rules and exit taxation.

However, E.U. Member States that have already implemented targeted rules for preventing B.E.P.S. that are equally as effective as the A.T.A.D. provisions have been granted a transitional extension period. Such Member States may continue to apply their existing rules until the end of the first fiscal year following the date of publication of an agreement between the O.E.C.D. Member States on a minimum standard with regard to B.E.P.S. Action 4 or, at the latest, until January 1, 2024.



As far as France is concerned, the French government has given notice that it is of the opinion that French law includes provisions equally as effective as the A.T.A.D. Foreign investors may, therefore, have to comply with France's current complex rules until the advent of the deadline for transposing the A.T.A.D. into domestic law.

# ITALY

**Author**  
Luca Rossi  
*Facchini Rossi & Soci*  
Milan, Italy

## CORPORATE TAX RATE

As with any Italian-resident company, an Italian-resident holding company is subject to corporation income tax (“I.R.E.S.”) levied on the worldwide income of the company at a flat rate of 24%, as provided in the Income Tax Code (“I.T.C.”).<sup>1</sup>

A regional tax on productive activities (“I.R.A.P.”) also applies to the net value of production performed in Italy. This tax is imposed at the general rate of 3.90%.<sup>2</sup> Higher rates are applicable to banks and other financial institutions (4.65%) and to insurance companies (5.90%). In addition, different regions of Italy may provide for a 0.92% variation of the abovementioned rates.<sup>3</sup>

It should be noted that a holding company that is legally classified as an Italian fixed capital investment company (*i.e.*, a *società di investimento a capitale fisso*, or “S.I.C.A.F.”) is subject to the tax regime applicable to undertakings for collective investment (see **Automatic Exchange of Information** below).

## DIVIDEND EXEMPTION

### Domestic Dividends

In general, the I.T.C. provides for a 95% exemption with regard to dividend distributions received from a domestic Italian company, whereby no withholding tax is imposed and the effective tax rate is 1.2%.<sup>4</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

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<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 dated December 15, 1997, n. 446.

<sup>3</sup> Article 16 of Legislative Decree n. 446 of December 15, 1997, as amended by the Law Decree n. 66 of April 24, 2014, converted into Law n. 89 of June 23, 2014.

<sup>4</sup> 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% ( $0.05 \times 0.24 = 0.012$ ).

*“A holding company that is legally classified as an Italian fixed capital investment company is subject to the tax regime applicable to undertakings for collective investment.”*

shares, or other financial assets qualifying as “held for trading” are fully taxable.<sup>5</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>6</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 for controlled foreign company (“C.F.C.”) purposes (a “Blacklist” jurisdiction, as defined in **C.F.C. Legislation** below) are fully taxable, unless income has been already taxed in the hands of the Italian recipient under the applicable C.F.C. rules<sup>7</sup> or a favorable ruling is obtained from the Italian tax authorities.<sup>8</sup> To receive a favorable ruling, the taxpayer must demonstrate that the purpose of the investment was not to obtain the benefits of a preferential tax regime (*i.e.*, “Condition 2” of the C.F.C. legislation, as defined in **C.F.C. Legislation**).<sup>9</sup> Effective 2015, the advance ruling is no longer mandatory, provided that Condition 2 can be proved during a tax audit. Where an advance ruling has not been requested or a positive ruling was not obtained, dividends from Blacklist-resident entities must be disclosed on the relevant tax return.<sup>10</sup>

Dividends corresponding to profits already taxed in the hands of an Italian-resident controlling company under the C.F.C. rules are not taxed again upon actual receipt (see also **C.F.C. Legislation**).

<sup>5</sup> Article 89(2-*bis*) I.T.C.

<sup>6</sup> See Article 83, I.T.C. as recently modified by Article 13-*bis*(2) of the Law Decree n. 244 of December 30, 2016.

<sup>7</sup> In this case, a foreign tax credit will be available for taxes paid on C.F.C. income.

<sup>8</sup> See **C.F.C. Legislation**.

<sup>9</sup> The Italian shareholder may also be exempt from the application of the C.F.C. rules if the nonresident subsidiary carries out an effective industrial or commercial business activity in the Blacklist jurisdiction (*i.e.*, “Condition 1” of the C.F.C. legislation, as defined in **C.F.C. Legislation**). However, under Condition 1, dividends from Blacklist countries are fully taxable and a foreign tax credit will be available for tax paid on the income of the Blacklist subsidiary (see Article 47 I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015).

<sup>10</sup> Article 89(3) I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015.

Full taxation applies only to Blacklist dividends derived directly from a participation in a Blacklist-resident subsidiary, or indirectly through a controlled foreign subsidiary in a non-Blacklist country with Blacklist-resident participations.

## PARTICIPATION EXEMPTION FOR GAINS

The I.T.C. provides for a 95% exemption regime for gains derived from the sale of shares of a subsidiary. According to Article 87 I.T.C., the exemption applies to the disposal of participations in both Italian and foreign subsidiaries.

Several conditions must be met to qualify for the exemption:

- Shares in the subsidiary must have been held for an uninterrupted period of 12 months prior to disposal. In measuring the holding period of shares acquired over time, a “Last-In, First-Out” rule applies; direct tracing is not permitted.
- The participation must be classified as a fixed financial asset on the shareholder’s first balance sheet reflecting the beginning of the holding period for the shares.
- In the three fiscal years preceding the disposal of the participation, the subsidiary must be tax resident in Italy or in a jurisdiction that is not a Blacklist country or territory (see also **C.F.C. Legislation** below). If the company is resident in a Blacklist jurisdiction, the shareholder may request a ruling from the Italian tax authorities verifying that the purpose of the investment was not to obtain the benefits of a preferential tax regime. As of 2015, an advance ruling is no longer mandatory provided that this condition can be proven during a tax audit. Where an advance ruling has not been requested or a positive ruling was not obtained, capital gains from Blacklist-resident entities must be disclosed on the relevant tax return.<sup>11</sup>
- The subsidiary must have been engaged in an active business since the beginning of the third financial year preceding the sale of the participation (unless its shares are traded on a stock exchange).

Several conditions apply to the foregoing tests. Under the anti-avoidance rules, a company is deemed not to be carrying out an active business if the predominant asset is real estate, as reported on a company’s balance sheet. Where a subsidiary is a holding company, the law requires that tests regarding tax residence and business activity be applied at the level of the subsidiary operating companies. Where the participation exemption applies to a gain, only a portion of costs related to the sale is deductible, equal to the percentage of the gain that is taxable, *viz.*, 5%.

## INTEREST DEDUCTION

Finance Act 2008 has completely redefined the interest deduction regime for companies subject to I.R.E.S.

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<sup>11</sup> *Id.*, Article 87(1).

The new regime, in general, provides as follows:<sup>12</sup>

- Interest expense is fully deductible in each tax period for an amount equal to interest income.
- The excess amount of interest expense can be deducted subject to a cap of 30% of an amount substantially corresponding to earnings before interest, taxes, depreciation, and amortization (“E.B.I.T.D.A.”), as measured in the borrower’s profit and loss statement.
- The amount of interest expense that exceeds the 30% limit is, therefore, not deductible in the tax period incurred, but may be carried forward indefinitely until it can be absorbed in a year when sufficient E.B.I.T.D.A. exists.
- The excess E.B.I.T.D.A. generated in each fiscal year may be carried forward and used to increase the E.B.I.T.D.A. of the following periods.

While banks and insurance companies, along with their holding companies and certain other financial institutions, are excluded from the interest deduction regime, it does apply to “industrial holding companies,” *i.e.*, companies whose main business consists of holding participations in other entities that do not carry on lending activities or financial services to the public.<sup>13</sup> Industrial holding companies are likely to be penalized by these provisions. Although, if they participate in domestic consolidation rules (see **Group Consolidation**), the excess interest expense of the holding company can be used to reduce the consolidated tax base generated by other associated companies, if and to the extent that such other group companies report E.B.I.T.D.A. not used to support their own deductions. This rule also applies in the case of interest expense carried forward by a company, provided it has been generated during the period of fiscal consolidation.

Separate specific rules apply to banks and insurance companies.

In the past few years, the deductibility of interest incurred in connection with merger-leveraged buyout acquisitions has been challenged by the Italian Tax Authorities based on anti-abuse rules or due to a lack of connection with the activities of the target.

In Circular Letter n. 6/E of March 30, 2016, the Italian Revenue Agency clarified that, as a general principle, interest on an acquisition loan may be deductible if

- the acquisition debt is functionally connected to the leveraged acquisition, and therefore, the deductibility of interest borne on loans granted by third parties should not be challenged; or
- the leveraged transaction is not considered abusive, *i.e.*, based on specific circumstances, it cannot be demonstrated that the operation is intended to obtain a tax advantage that is contrary to the spirit and objectives of the law; an example of an abusive transaction is a releveraging transaction in the absence of a change of control.

<sup>12</sup> See *id.*, new Article 96.

<sup>13</sup> *Id.*, Article 96(5).

*“To receive a favorable ruling, the taxpayer must demonstrate that the purpose of the investment was not to obtain the benefits of a preferential tax regime.”*

## MINIMUM TAXABLE INCOME FOR NON-OPERATING COMPANIES

Specific anti-avoidance rules apply to non-operating companies and non-operating permanent establishments in Italy. Under Article 30 of the Law dated December 23, 1994, n. 724, an entity is deemed to be a non-operating company when the sum of its turnover, increase in inventory, and revenue (as reported on its profit and loss statement) is lower than a specified base. The base is the sum of the following items: (i) 2% of the total value of participations in resident and nonresident companies, bonds, other financial instruments, and financial credits; (ii) 4%-6% of the value of real estate and ships owned or leased by the company; and (iii) 15% of the value of other fixed assets. The calculation is made on the average values over a three-year period (*i.e.*, the tax period concerned and the two preceding periods).

When a company is a non-operating company under the foregoing definition, it is taxed at a rate of 34.5% on minimum income.<sup>14</sup> Minimum income is calculated by applying a deemed return to the assets mentioned above. The deemed returns are (i) 1.50% of participations, other financial instruments, and financial credits; (ii) 4.75% of real estate values (reduced to a 3%-4% rate for residential real estate assets and offices); and (iii) 12% of other fixed assets.

A non-operating company may attempt to demonstrate to the Italian tax authorities that specific facts and circumstances prevented it from achieving the minimum turnover and thereby receive a ruling to qualify for the exception. Where an advance ruling has not been requested or a positive ruling was not obtained, the taxpayer can disclose the existence of such conditions on the relevant tax return.<sup>15</sup> There are also certain automatic exclusions from the scope of the general rule. Finance Act 2008<sup>16</sup> has increased the number of these exclusions, notably for

- companies in the first year of activity;
- companies whose shares are traded on a stock exchange, as well as the subsidiaries and controlling shareholders of such companies;
- companies that have had at least ten employees in the two preceding fiscal periods;
- companies whose value of production, as measured on the profit and loss statement, is greater than the total value of assets reported on the balance sheet;
- companies holding participations in subsidiaries that are considered “operating” companies or that have obtained a positive ruling; and
- companies in insolvency proceedings.

Following the amendments made by Article 2 of Law Decree n. 138 of August 13,

<sup>14</sup> A surtax of 10.5% is applicable. See Article 2(36-*quinquies*) of Decree Law n. 138 of August 13, 2011.

<sup>15</sup> Article 30(4-*quater*) of Law n. 724/1994, as modified by Article 7 of Legislative Decree n. 156 of September 24, 2015.

<sup>16</sup> Law n. 244 of December 24, 2007.

**“After the introduction of the participation exemption regime, holding companies cannot reduce income through unrealized losses in participations.”**

2011, the foregoing provisions are also applicable to companies that have (i) incurred fiscal losses for at least five consecutive tax years, or (ii) incurred fiscal losses for four out of the five years of assessment and in one year have reported income that is lower than the minimum income, as determined in the manner described above. Beginning in the sixth consecutive tax year, those companies will be deemed to be non-operating companies even though they do not meet the usual requirements to do so provided by Article 30(1) of the Law dated December 23, 1994, n. 724.

## ALLOWANCE FOR CORPORATE EQUITY

In order to encourage companies to strengthen their financial structures by using equity rather than debt, Article 1 of Law Decree n. 201 of December 6, 2011 introduced the Allowance for Corporate Equity (“A.C.E.”), whereby a notional return on the increase in equity generated after 2010<sup>17</sup> may be deducted from total net income if it is derived from capital contributions and the retention of earnings. The amount of A.C.E. that exceeds the net taxable income of the year can be carried forward and used to offset the net taxable base of a subsequent tax period, or it can be converted into a tax credit equal to 24% of the notional yield to offset (in five equal annual installments) the I.R.A.P. due for each tax year.

Ministerial Decree of August 3, 2017 (hereinafter “the Decree”), which explicitly abrogated the former Decree of March 14, 2012,<sup>18</sup> contains the operative provisions of this rule. The A.C.E. applies as of the tax year in which December 31, 2011 falls. The benefit may be claimed by

- companies resident in Italy, as indicated by Article 73(1)(a) I.T.C.;
- state and private entities other than companies, as well as trusts resident in Italy, whose main or exclusive objective is to carry out a commercial activity, as indicated by Article 73(1)(b) I.T.C.;
- Italian permanent establishments of nonresident companies and entities, as indicated by Article 73(1)(d) I.T.C.; and
- individuals, S.N.C.’s, and S.A.’s regulated by ordinary accounting rules.

The A.C.E. is determined by applying a given percentage rate to the net increase in equity, which in turn is calculated as the excess of the equity book value at the end of the year over the equity book value resulting from the balance sheet as of December 31, 2010. The increase in equity book value attributable to the increase in retained earnings for the year is not considered.<sup>19</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

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<sup>17</sup> Article 1(2) of Law Decree n. 201 of December 6, 2011, as recently modified by Article 7(1) of Law Decree n. 50 of April 24, 2017.

<sup>18</sup> See Article 13 of the Decree.

<sup>19</sup> *Id.*, Article 4.

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>20</sup>

The net increase in any particular year cannot exceed the value of the net equity at the end of that year.<sup>21</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>22</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 (for instance, through dividend distributions or equity reductions).

For the 2017 tax year, the notional deduction is 1.6%, and from the 2018 tax year onwards the rate will be 1.5%.<sup>23</sup>

The so-called “Super-A.C.E.” regime aimed at listed companies has been repealed.

Specific rules are provided for companies participating in a group consolidation<sup>24</sup> and for companies opting for the “transparency regime” under Articles 115 and 116 I.T.C.<sup>25</sup>

Article 10 of the Decree provides specific anti-avoidance rules, especially for companies belonging to a group.

## GROUP CONSOLIDATION

After the introduction of the participation exemption regime, holding companies cannot reduce income through unrealized losses in participations. However, group consolidation is permitted. Two consolidation regimes exist. One is known as the domestic consolidation regime,<sup>26</sup> and the other is the international or worldwide consolidation regime.<sup>27</sup>

### Domestic Consolidation

For the purpose of the domestic consolidation regime, a group of companies is

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<sup>20</sup> See *id.*, Article 5(6) for the definition of “non-available reserves.”

<sup>21</sup> *Id.*, Article 11.

<sup>22</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>23</sup> Article 1(3) of Law Decree n. 201 of December 6, 2011, as recently modified by the last version of Article 7 of Law Decree n. 50 of April 24, 2017, as amended by Italian Parliament on June 15, 2017.

<sup>24</sup> Article 6 of the Decree.

<sup>25</sup> *Id.*, Article 7.

<sup>26</sup> Article 117-129, I.T.C.

<sup>27</sup> *Id.*, Article 130-142.

comprised of a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two factors exist. First, the common parent must, directly or indirectly, have more than 50% of the voting rights at the subsidiary's general shareholders' meeting. Second, the common parent must, directly or indirectly, be entitled to more than 50% of the subsidiary's profits. The "de-multiplier effect" must be considered in both cases.

Under certain circumstances, a nonresident company may participate in a domestic consolidation as the common parent of the group. First, the foreign parent must be a resident in a country that has a tax treaty in effect with Italy. Second, it must carry out business activities in Italy through a permanent establishment. Legislative Decree n. 147 of September 14, 2015 introduced a "horizontal" tax consolidation regime. With effect from 2015, this regime allows a parent entity that is resident in an E.U. Member State or E.E.A. Country that has signed an agreement with Italy allowing the effective exchange of information to designate an Italian-resident subsidiary or permanent establishment as a "consolidating" entity. The consolidating entity may then form a single fiscal unit with another direct or indirect subsidiary of the same parent company. Legislative Decree n. 147 also introduced legislation whereby Italian permanent establishments of E.U./E.E.A. companies may form a consolidated fiscal unit with other Italian-resident companies of the same group.



The domestic consolidation regime only applies when an election has been made by the common parent and the participating controlled subsidiaries; all subsidiaries are not required to participate in the regime. Once an election is made, the domestic consolidation is effective for three tax periods. If the requisite degree of control in a subsidiary is relinquished during this time, that subsidiary no longer participates.

The domestic consolidation regime works as follows. Each company determines its taxable income or loss on an individual basis, according to the ordinary rules, and submits its own tax return (without computing the relative income tax or credit). Then, the common parent aggregates the group's taxable income or loss and computes the consolidated income tax or credit. The total taxable income or loss of each controlled subsidiary is considered regardless of the percentage held by the common parent.

Domestic consolidated groups may take advantage of a rule that allows for a combined computation of E.B.I.T.D.A. and interest expense (see **Interest Deduction** above).

A separate limitation rule applies to losses incurred during a tax period in which a company did not participate in the consolidation regime. These losses are ring-fenced in that company and cannot be brought forward to reduce group income.

### **Worldwide Consolidation**

In addition to the domestic regime, Italian law allows for worldwide consolidation where an Italian-resident company controls one or more nonresident companies. In order for a nonresident company to participate, its financial statements must be audited. 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>28</sup>

<sup>28</sup> *Id.*, Article 132(3).

Several differences exist between the domestic consolidation regime and the worldwide regime. First, the worldwide regime is not selective among group members. The option must be exercised by *all* of the nonresident controlled subsidiaries. Furthermore, the first election for worldwide consolidation is effective for five tax periods, and any subsequent renewal is effective for three tax periods. It is believed that the option for worldwide consolidation has been exercised only by a few Italian groups of companies.

### **C.F.C. Legislation**

Profits realized by a C.F.C. are deemed to be the profits of an Italian company if the two following conditions are met:

- The resident company directly or indirectly controls the nonresident entity.
- The foreign entity is resident in a jurisdiction that has a privileged tax regime.<sup>29</sup>

According to Article 167(1), the C.F.C. rule is not applicable to companies or other entities established in an E.U. Member State or E.E.A. Country that has signed an agreement with Italy allowing the effective exchange of information.

As of 2016, a country or territory is deemed to have a privileged tax regime if its nominal income tax rate is less than 50% of the applicable Italian tax rate.<sup>30</sup> Until 2015, the jurisdictions with privileged tax regimes were listed in Ministerial Decree dated November 21, 2001 (the so-called “Blacklist”), as modified by the Ministerial Decree of March 30, 2015.

For purposes of the C.F.C. regime, control is defined according to the Italian Civil Code.<sup>31</sup> A company may be deemed to be controlled in one of three circumstances:

- The Italian resident holds, directly or indirectly, the majority of the voting rights exercised at the general shareholders’ meeting of the company.
- The Italian resident holds, directly or indirectly, sufficient votes to exert a decisive influence in the shareholders’ meeting of the company.
- The Italian resident exercises a dominant influence over the company due to contractual relationships.

In order to avoid the application of the C.F.C. regime, an Italian-resident company may request a ruling from the Italian tax authorities and provide evidence that (i) the nonresident company carries out an effective industrial or commercial business activity in the market/territory of the country where it is located (“Condition 1”), or (ii) the Italian company does not benefit from a diversion of income into a privileged tax regime (“Condition 2”). As of 2015, an advance ruling is no longer mandatory, provided that the taxpayer can prove during a tax audit that the abovementioned conditions have been met. Where an advance ruling has not been requested or a

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<sup>29</sup> *Id.*, Article 167, as recently modified by Article 1 (142) of Legislative Decree n. 147/2015.

<sup>30</sup> The nominal tax rate test should be determined by computing both the corporate income tax rate applicable (“I.R.E.S.”) and the rate of the regional tax on productive activities (“I.R.A.P.”) ordinarily applicable (see Circular letter n. 35/E of August 4, 2016, ¶1.2).

<sup>31</sup> Article 2359 of the Civil Code.

positive ruling was not obtained, the holding of C.F.C. participations must be disclosed on the relevant tax return. Concerning Condition 1, Law Decree n. 78/2009 introduced the following changes:

- With respect to banking, financial, and insurance activities, the condition is deemed to be met when the main portion of the respective sources, investments, and proceeds originate in the state or territory where the foreign company is located.
- The condition is never met when more than 50% of the foreign company's proceeds are derived from (i) the management, holding, or investment in securities, shares, receivables, or other financial assets; (ii) the transfer of or license to use intangible rights of industrial, literary, or artistic property; or (iii) the supply of services, including the financial ones, within the group.<sup>32</sup>

Law Decree n. 78/2009 has also broadened the scope of the C.F.C. rules to include controlled companies not resident in jurisdictions that have a privileged tax regime, even companies or other entities established in E.U. Member States or E.E.A. Country that has signed an agreement with Italy allowing the effective exchange of information, if the following conditions are both met:

- The C.F.C. is subject to actual taxation that is less than 50% of the tax that would have been levied if it were resident in Italy; and
- More than 50% of the profits of the C.F.C. are derived from the management, holding, or investment in securities, shares, receivables, or other financial assets, from the disposal or licensing of intellectual property rights, or from the performance of intra-group services.<sup>33</sup>

A safe harbor clause provides that under certain circumstances the C.F.C. rules will not be applicable even if the company meets the conditions outlined above. To qualify for the safe harbor exemption, the resident shareholder must demonstrate that the formation of the C.F.C. in a specific foreign country does not constitute an artificial scheme aimed at achieving undue tax advantages.<sup>34</sup> This can be achieved by applying for an advance tax ruling. In cases where an advance ruling was not requested or a positive ruling was not obtained, an exemption under the safe harbor clause may also be disclosed on the taxpayer's relevant tax return.

If the C.F.C. rules apply, the profits of the C.F.C. are deemed to be the profits of the Italian resident. These profits are taxed separately at the average tax rate for Italian-resident corporations, which is 24%.

Italian law provides for the concept of "previously-taxed income." As a result, when profits that were previously attributed to the resident company are distributed in the form of a dividend, the dividend does not constitute taxable income upon receipt.

## TREATY PROTECTION

Italy has tax treaties in effect with over 90 jurisdictions, including many developed

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<sup>32</sup> Article 167(5-*bis*), I.T.C.

<sup>33</sup> *Id.*, Article 167(8-*bis*).

<sup>34</sup> *Id.*, Article 167(8-*ter*).

countries and significant trading partners. In general, the treaties provide for reduced withholding tax rates in line with the O.E.C.D. Model Treaty. Notable exceptions exist for withholding tax on interest. In the new treaty with the U.S., the withholding tax rate is 10%.

Listed below are the countries that have income tax treaties with Italy that are currently in force and effect:

Albania	Algeria	Argentina	Armenia
Australia	Austria	Azerbaijan	Bangladesh
Barbados	Belarus	Belgium	Bosnia & Herzegovina
Brazil	Bulgaria	Canada	Chile
China	Congo (Rep.)	Croatia	Cyprus
Czech Republic	Denmark	Ecuador	Egypt
Estonia	Ethiopia	Finland	France
Georgia	Germany	Ghana	Greece
Hong Kong	Hungary	Iceland	India
Indonesia	Ireland	Israel	Ivory Coast
Japan	Jordan	Kazakhstan	Kuwait
Latvia	Lebanon	Lithuania	Luxembourg
Macedonia	Malaysia	Malta	Mauritius
Mexico	Moldova	Montenegro	Morocco
Mozambique	Netherlands	New Zealand	Norway
Oman	Pakistan	Panama	Philippines
Poland	Portugal	Qatar	Romania
Russia	San Marino	Saudi Arabia	Senegal
Serbia	Singapore	Slovakia	Slovenia
South Africa	South Korea	Spain	Sri Lanka
Sweden	Switzerland	Syria	Taiwan
Tajikistan	Tanzania	Thailand	Trinidad & Tobago
Tunisia	Turkey	Turkmenistan	Uganda
Ukraine	United Arab Emirates	United Kingdom	United States
Uzbekistan	Venezuela	Vietnam	Zambia

*“Italian law provides that dividends distributed by Italian companies are subject to a 26% withholding tax.”*

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

## WITHHOLDING TAXES ON OUTBOUND PAYMENTS

### **Dividend Withholding – Domestic Law**

In general, Italian law provides that dividends distributed by Italian companies are subject to a 26% withholding tax.<sup>35</sup> The rate may be reduced to 11% for dividends paid out to pension funds established in E.U. Member States or E.E.S. Countries (*i.e.*, Iceland, Liechtenstein, and Norway) listed in Ministerial Decree September 4,

<sup>35</sup> Law Decree n. 66/2014, converted into Law n. 89 of June 23, 2014.

1996. The recipient can claim a refund of up to eleven twenty-sixths of the withholding tax incurred, if taxes have been paid on the same income in its country of residence.<sup>36</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. Member States or E.E.S. Countries included on the abovementioned list, a reduced 1.2% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions made to domestic companies (see **Dividend Exemption** above). If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are treated as described above (subject to a 95% exemption).

### **Parent-Subsidiary Directive**

Under the Parent-Subsidiary Directive (the “P.S.D.”) as implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may claim a refund of 26% or 1.2% for withholding tax levied on dividends distributed by Italian subsidiaries. After the amendments enacted by Directive 2003/123/C.E.,<sup>37</sup> the required minimum for direct shareholding in the Italian company was reduced to 10%.

In order for a company to qualify as a parent for the benefit of the P.S.D., certain requirements must be met. First, it must have one of the corporate forms listed in the P.S.D. Second, it must reside for tax purposes in an E.U. Member State. For this purpose, a dual resident company is not considered to be a resident of an E.U. Member State if its residence is allocated to a jurisdiction outside the E.U. under an income tax treaty. Third, the company must be subject to one of the income tax regimes listed in the P.S.D. without the possibility of opting for favorable regimes or exemptions. Finally, it must have held the participation for an uninterrupted period of at least one year.

To demonstrate compliance with the first three conditions, a certificate issued by a foreign tax authority must be submitted. The last condition is corroborated by a declaration. Once the foregoing conditions have been met, the exemption is mandatory.

The general anti-abuse rule (“G.A.A.R.”) applies. Therefore, an E.U. parent may not benefit from an exemption arising from holdings that are shown to be artificial or that have been established with the sole or primary purpose of taking advantage of the exemption.<sup>38</sup>

As clarified in Circular Letter n. 6/E of 30 March 2016, under G.A.A.R., the intermediate entity is deemed to have been set up merely as a “conduit entity” or as a part of a “conduit arrangement” if at least one of the following circumstances is met:

- The intermediate entity has a light organization (e.g., employees, offices, and equipment are made available by third companies through management

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<sup>36</sup> Article 27(3) of Presidential Decree n. 600/1973.

<sup>37</sup> Implemented in Italy by Legislative Decree dated February 6, 2007, n. 49. Article 27-*bis* of Presidential Decree n. 600/1973.

<sup>38</sup> See the last paragraph of Article 27-*bis* of Presidential Decree n. 600/1973.

service agreements) and does not carry out real economic activity or has little or no discretion in the decision-making process (a “conduit entity”).

- The intermediate entity acts merely as a financial conduit in the context of a specific arrangement (e.g., inbound and outbound payments are symmetrical in term of amount, maturity, etc.), allowing payment to flow through without incurring an additional tax burden because it is not subject to further withholding tax in the state where the intermediate is located (a “conduit arrangement”).<sup>39</sup>

### **Interest and Royalties**

Italy has implemented the Interest and Royalties Directive providing for a withholding exemption on payments of interest and royalties made to associated companies resident in E.U. Member States.<sup>40</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 P.S.D. Annex B, and (b) has one of the corporate forms listed in P.S.D. Annex A. Alternatively, the recipient can be a permanent establishment of a company resident in a Member State, granted the permanent establishment is also situated in a Member State. Moreover, the nonresident recipient must be the beneficial owner of the payments.<sup>41</sup>

Two companies may be deemed to be associated under one of two tests: (i) one of the companies directly holds at least 25% of the voting rights at the general shareholders’ meeting of the other company, or (ii) a third company, resident in a Member State and having one of the corporate forms listed in P.S.D. Annex A, directly holds at least 25% of the voting rights in both companies. The requisite ownership must be held for at least one year.

Article 23(1) of Law Decree n. 98 of July 6, 2011 introduced a new 5% withholding tax applicable to interest paid to a nonresident that is not the beneficial owner of the payments, provided that

- the abovementioned conditions (a) and (b) are met;
- the interest payment is intended to finance the payment of interest and other proceeds on bonds issued by the recipient;
- the bonds are traded on an E.U.- or E.E.S.-regulated market; and
- the bonds are guaranteed by the paying company, the holding company, or another subsidiary.<sup>42</sup>

Pursuant to Article 26, paragraph 5 of Presidential Decree 600/1973, interest payments made to lenders not resident in Italy are subject to a final withholding tax at a rate of 26%. Double taxation treaties in force between Italy and the lender’s country of residence may apply, allowing for a lower withholding tax rate (generally 10%), subject to compliance with relevant subjective and procedural requirements.

<sup>39</sup> See Circular Letter n. 6/E, issued by the Italian Revenue Agency on March 30, 2016.

<sup>40</sup> Article 26-*quater*, Presidential Decree n. 600/1973.

<sup>41</sup> For the definition of “beneficial owner” see *id.*, Article 26-*quater* (4).

<sup>42</sup> For more details, see *id.*, Article 26-*quater*(8-*bis*).

**“Italy has implemented the Interest and Royalties Directive providing for a withholding exemption on payments of interest and royalties made to associated companies resident in E.U. Member States.”**

However, according to paragraph 5-*bis*<sup>43</sup> of the same Article, final withholding tax does not apply to interest payments on medium-long term loans<sup>44</sup> granted to commercial entities by

- credit institutions established in E.U. Member States;
- insurance companies incorporated and authorized under the law of E.U. Member States;
- foreign institutional investors, regardless their tax status, established in Whitelisted jurisdictions and subject to regulatory supervision therein; or
- certain non-banking, state-owned entities (such as the U.K. National Savings Bank).

The abovementioned exemption is available only when the laws governing lending activities to the public are not infringed. Therefore, to benefit from the exemption, the lender must comply with all of the regulatory requirements for lending to the public. In particular, credit funds must be E.U. Alternative Investment Funds (“E.U. A.I.F.”). Direct lending is not allowed by non-E.U. A.I.F.’s. To perform direct lending activity in Italy, an E.U. A.I.F. must meet the following conditions:

- It must be authorized to lend by the competent authority in its home Member State.
- It must be a closed-end fund and its operating rules, including those relating to its investors, must be similar to those applicable to Italian credit funds.
- The rules on risk diversification and limitation, including limitations on leverage, applicable to it under the regulations of its home Member State must be equivalent to those applicable to Italian credit funds.

An E.U. A.I.F. planning to commence lending activities in Italy must give prior notice to the Bank of Italy, which then has sixty days to issue a response preventing the E.U. A.I.F. from commencing operations. If this period passes without any communication from the Bank of Italy, lending activities may commence.

### **Nonresident Company with a Permanent Establishment**

Companies with a permanent establishment in Italy are taxed on the income of the permanent establishment. Permanent establishment income is determined under the rules applicable to income of resident companies, including the participation exemption regime (see **Participation Exemption for Gains**). Pursuant to the new Article 152(2) I.T.C., replaced by Article 7(3) of Legislative Decree n. 147 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

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<sup>43</sup> Introduced by Article 22(1) of Law Decree n. 91 of June 24, 2014.

<sup>44</sup> Medium-long term loans are loans that have a contractual duration of more than 18 months and 1 day and do not provide a prepayment option for the lender.

should account for the functions performed, assets used, and risks assumed by the enterprise through the permanent establishment.

Article 152(2) also provides that adequate “free capital” must be attributed to the permanent establishment for tax purposes. Again, the amount is determined based on O.E.C.D. principles (*i.e.*, taking into account the functions performed, assets used, and risks assumed by the permanent establishment).

### **Nonresident Company with No Permanent Establishment**

Nonresident companies without a permanent establishment in Italy are taxed on income generated in Italy under the rules applicable to resident individuals.<sup>45</sup> In particular, they are deemed not to have business income.

Where the foreign corporation sells an interest in an Italian subsidiary, the tax treatment depends on whether the participation is qualified.

If the participation is qualified, 58.14% of the capital gains are included in taxable income and are subject to I.R.E.S.<sup>46</sup> However, due to the changes introduced by the Budget Law for 2018,<sup>47</sup> the partial exemption has been eliminated for capital gains realized on the disposal of qualified participation after January 1, 2019.<sup>48</sup> Accordingly, such capital gains will be subject to a 26% substitute tax.<sup>49</sup>

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>50</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>51</sup>

Finally, if (i) the participation is not qualified, (ii) the disposition relates to a participation in a private company, and (iii) the shareholder is resident in a country without adequate exchange of information, capital gains are subject to a 26% substitute tax.<sup>52</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

<sup>45</sup> Article 151(3), I.T.C.

<sup>46</sup> *Id.*, Article 68(3). The percent of capital gains which are exempt has been increased from 49.72% to 58.14% by Ministerial Decree of May 26, 2017 and applies to capital gains realized after January 1, 2018. The increase was necessary in order to account for the lowering of the corporation income tax rate from 27.5% to 24% applicable as of fiscal year 2017 (see Article 1(64) of Law n. 208 of December 28, 2015).

<sup>47</sup> Article 1(999) of Law n. 205 of December 27, 2017.

<sup>48</sup> *Id.*, Article 1(1005).

<sup>49</sup> Article 5(2) of Legislative Decree n. 461 of November 21, 1997.

<sup>50</sup> Article 23(1)(f) I.T.C.

<sup>51</sup> Article 5(5)(a), Legislative Decree n. 461/1997.

<sup>52</sup> *Id.*, Article 5(2).

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>53</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” – it is applicable to all qualified existing permanent establishments. Branches falling within the scope of the C.F.C. rules will not qualify unless one of the conditions for C.F.C. exemption is met (see **C.F.C. Legislation**).

A loss recapture provision applies if the branch has incurred a net tax loss over the five-year period prior to the election. In this case, branch income will be included in the taxable basis of the Italian parent company, up to the amount of the pre-existing tax losses, with a corresponding foreign tax credit.

## FOREIGN TAX CREDIT

A foreign tax credit is granted to avoid international double taxation.<sup>54</sup> The tax credit is calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period.<sup>55</sup>

## TRANSFER PRICING

The Italian transfer pricing regime appears in Article 110(7) I.T.C. and the 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. Reports on Action Items 8, 9, and 10.

Pursuant to Article 110(7),<sup>56</sup> business income of an Italian-resident enterprise derived from (i) transactions with a nonresident company<sup>57</sup> that is directly or indirectly controlled by the Italian enterprise; (ii) operations where the foreign company controls the Italian company; or (iii) transactions between resident and nonresident companies that are under the common control of a third company, is assessed on the basis of conditions and prices that would be agreed upon by independent parties operating at arm's length conditions and in comparable circumstances.

Following certain amendments,<sup>58</sup> Article 110(7) no longer refers to the “normal

<sup>53</sup> See the new Article 168-*ter* I.T.C., introduced by Article 14 of Legislative Decree n. 147/2015.

<sup>54</sup> Article 165, I.T.C.

<sup>55</sup> *Id.*, Article 165(6).

<sup>56</sup> As amended by Article 59 of the Law Decree n. 50 of April 24, 2017.

<sup>57</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>58</sup> See Article 59 of Law Decree n. 50 of April 24, 2017.



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>59</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

- binding agreements concluded with the competent authorities of a Contracting State pursuant to a mutual agreement procedure provided for by a double tax treaty or E.U. Directive 90/436 (the “Arbitration Convention”);
- the completion of tax audits carried out in accordance with the Convention on Mutual Administrative Assistance in Tax Matters; or
- rulings requested by the taxpayer in which the tax authorities of a Contracting State with an adequate exchange of information with Italy have made a corresponding and definitive upward tax adjustment according to the arm’s length principle – in such a case, the taxpayer’s right to request a resolution under the mutual agreement procedure of the applicable tax treaty or the Arbitration Convention remain unchanged.

Legislative Decree 78 of May 31, 2010 introduced Italian regulations for intercompany transfer pricing documentation. Although such documentation is not mandatory, this decree waives the application of administrative penalties (otherwise ranging from 90% to 180% of the tax assessed) if the taxpayer provides the relevant transfer pricing documentation to the tax authorities during a tax audit.

Over the past few years, the Italian tax authorities have paid increasing attention to intra-group transactions during tax audits, and the number of audits of intra-group transactions within multinational groups has risen.

## PATENT BOX REGIME

In 2015, an optional “Patent Box” regime was introduced in Italy by Article 1 of Law n. 190 of December 23, 2014<sup>60</sup> and enacted by Ministerial Decree dated July 30, 2015.

The exercise of this option is binding for a period of five years and it can be renewed.

The Patent Box regime grants a 50% exemption (reduced to 30% for 2015 and 40% for 2016) from I.R.E.S. and I.R.A.P. on income derived from certain intangible assets, such as patents, copyright protected software, and other intellectual property (“I.P. assets”). According to Article 59 of the Law Decree n. 50 of April 24, 2017, trademarks are no longer considered eligible I.P. assets. The new provisions affect applications to the Patent Box regime submitted after December 31, 2016, while

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<sup>59</sup> As approved by the O.E.C.D. Council on July 10, 2017.

<sup>60</sup> Law Decree n. 3 of January 24, 2015 introduced a number of amendments to the regime introduced by Law n. 190/2014. These changes reflect the guidelines set out in the O.E.C.D.’s B.E.P.S. Report on Action Item 5 regarding the modified nexus approach for I.P. regimes (see **Patent Box Regime**).

*“An Italian-resident company may be exempt from Italian tax on income and losses arising from foreign permanent establishments.”*

applications submitted before December 31, 2016 are covered by grandfathering provisions and the terms of the previous regime will continue to be valid for the entire five-year duration of the Patent Box election. The provisions making trademarks ineligible were introduced in order to align the Italian Patent Box regime with O.E.C.D. Guidelines.

The Patent Box regime also applies to income derived from the joint use of intangible assets, linked to each other by complementary constraints, with the purpose of realizing a product (or a family of products) or a process (or a group of processes). In the latter case, all the jointly-used intangibles must be assets eligible for the regime. I.P. income – which is eligible for the exemption – is determined using a specific ratio of “qualifying expenses” (*i.e.*, certain research and development expenditures related to I.P. assets) to “overall expenses” (*i.e.*, the sum of the qualifying expenses and the acquisition costs of I.P. assets).<sup>61</sup>

In addition to the benefit for income generated from I.P. assets, the Patent Box regime also provides a special exemption for capital gains arising from the disposal of these assets. In order to benefit from this measure, at least 90% of the proceeds from the sale must be reinvested in maintenance or development of other I.P. assets. Reinvestment must take place by the end of the second fiscal year following the year in which the transfer occurred.

## 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. Moreover, the 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 exchange of information with the U.S. in relation to accounts held in Italian financial institutions by U.S. persons.
- Financial institutions must forward specified information to the Italian Tax Authorities, which will, in turn, transmit the data to the Internal Revenue Service.
- If certain conditions are met, holding companies may be subject to the F.A.T.C.A. reporting regime.
- Due to a deferment established by the Italian Tax Administration, the reporting deadline for information related to tax year 2017 is May 31, 2018 (the ordinary deadline is April 30 of the year following the fiscal year concerned).

<sup>61</sup> Article 9 of Ministerial Decree dated July 30, 2015.

Similar reporting requirements have recently been introduced for countries other than U.S. As of 2016, the Common Reporting Standard (the “C.R.S.”) and Directive 2014/107/E.U.<sup>62</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 the Ministerial Decree dated December 28, 2015.

Italian implementation of F.A.T.C.A., the C.R.S., and D.A.C.2 has a common purpose: to prevent tax evasion by foreign individuals who maintain financial relationships with Italian financial institutions. In particular, these regulations require Italian financial institutions to identify their customers in accordance with specific criteria and to communicate certain information (regarding, *inter alia*, interest income, dividends, and similar types of income; account balances; and sales proceeds from financial assets) to the relevant tax authorities.

## ITALIAN MEASURES TO COMBAT B.E.P.S.

Fifteen specific actions are being developed in the context of the O.E.C.D./G-20 project to combat base erosion and profit shifting (the “B.E.P.S. Project”). In substance, these actions cover all the principal aspects of international taxation – as they relate to C.F.C. rules, interest deductibility, artificial avoidance of permanent establishment status, transfer pricing rules, curbing harmful tax practices, data collection, mandatory disclosure rules, and dispute resolution.<sup>63</sup>

Italy is already compliant with most of these actions:

- As recommended by Action Item 13, Italy has introduced Country-by-Country Reporting obligations into domestic law (see Article 1(145-147) of Law n. 208 of December 30, 2015).
- In order to incorporate the guidelines under Action 5, Italy has introduced several amendments to the Patent Box regime in Law n. 190/2014 (see **Transfer Pricing** above). Revisions to the regime introduced by Decree Law n. 3/2015 ensure that Patent Box benefits are granted only to income that arises from intellectual property for which actual R&D activity was undertaken by the taxpayer. This treatment is in line with the nexus approach recommended in Action Item 5 (see the explanatory document of Law n. 190/2014). The provisions excluding trademarks from Patent Box eligibility were also introduced to align the Italian Patent Box regime with O.E.C.D. Guidelines.
- In order to promote tax transparency and disclosure initiatives under Action Items 5 and 11, a voluntary disclosure procedure has been introduced in Italy. In furtherance of this procedure (and O.E.C.D. recommendations), the Italian government has recently signed agreements with Andorra, Barbados, the Cayman Islands, Chile, Cook Islands, Gibraltar, Guernsey, Hong Kong, the Isle of Man, Jersey, Liechtenstein, Luxembourg, Monaco, San Marino, Switzerland, Taiwan, and Vatican City regarding the exchange of information.
- Following the guidelines set out in B.E.P.S. Action 7, the domestic definition

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<sup>62</sup> For exchanges between E.U. Member States, the E.U. has implemented the C.R.S. through D.A.C.2.

<sup>63</sup> For a list of all B.E.P.S. Actions, see Chapter 3 of this text, “[B.E.P.S. and Holding Companies](#).”

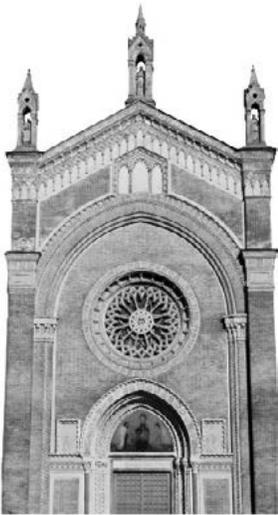
of “permanent establishment” was modified by Article 1(1010) of Budget Law 2018. In particular, it contained amendments providing new rules for the prevention of artificial avoidance of permanent establishment status through specific activity exemptions, clarifying that activities that fall under the “negative list” must have a preparatory and auxiliary character in order to qualify.<sup>64</sup> New rules have also been introduced to prevent the artificial avoidance of permanent establishment status through *commissionaire* arrangements.<sup>65</sup> An anti-fragmentation rule<sup>66</sup> and a new definition of “closely-related person” were also introduced.<sup>67</sup>

Moreover, many of the new tax rules provided by the International Tax Decree appear to be closely linked to B.E.P.S. Project reports released in 2014 and 2015, such as

- the modification of advance ruling procedures for international companies related to (i) transfer pricing operations, (ii) the existence of a permanent establishment, and (iii) the attribution of profits to a permanent establishment, in order to provide for the spontaneous exchange of information by the Italian tax authorities (see new Article 31-*ter* of Presidential Decree n. 600 of September 29, 1973, introduced by Article 1 (2) of the International Tax Decree);
- the (i) adoption of an “effectively connected income concept” for permanent establishments, repealing the so-called force of attraction rules, which – pursuant to previous rules – had provided for the taxation of certain income produced in Italy but not effectively linked to the permanent establishment, and (ii) introduction of the branch exemption regime (see **Nonresident Company with a Permanent Establishment** above); and
- the reform of the C.F.C. rules to provide for (i) the repeal of the mandatory ruling procedure in order to obtain exemption for foreign subsidiaries, and (ii) the abolition of C.F.C. regimes for “affiliated” companies (*i.e.*, at least 20%-owned by an Italian resident, or 10%-owned if the parent company is a listed company), among other revisions (see **C.F.C. Legislation** above).

Other tax measures provided by the International Tax Decree are intended to comply with rulings of the E.C.J. These include

- the new rules regarding domestic tax consolidation, which extend the option to apply the Italian consolidation regime to “sister” companies (including permanent establishments) that are controlled by the same foreign company resident in an E.U. Member State or E.E.A. Country, allowing adequate exchange of information (see **Domestic Consolidation** above);<sup>68</sup> and
- revisions to the regime for outbound transfers of tax residence, which (i) extend the possibility to defer exit tax on transfers of residence out of Italy as the result of a business merger, and (ii) expressly confirm the application of



<sup>64</sup> Article 162(4-4-*bis*) I.T.C.

<sup>65</sup> *Id.*, Article 162(6-7).

<sup>66</sup> *Id.*, Article 162(5).

<sup>67</sup> *Id.*, Article 162(7-*bis*).

<sup>68</sup> *SCA Group Holding and Others*, Joined Cases C-39-41/13, [2014] E.C.R. I \_\_\_\_\_ (delivered June 12, 2014).

the regime to Italian permanent establishments of foreign companies<sup>69</sup> (see Articles 166 and 179 I.T.C., as modified by Article 11 of the International Tax Decree).

Furthermore, Legislative Decree n. 128 of August 5, 2015 (the “Certainty Decree”) reviewed Italy’s anti-avoidance rules and anti-abuse regime. The Certainty Decree introduced a legal definition of “abuse of law” (see the new Article 10-*bis* of Law n. 212 of July 27, 2000) in order to improve “cooperative compliance,” as suggested by the O.E.C.D., and to comply with European Commission recommendations on aggressive tax planning (2012/772/E.U.).

## TAX REGIME FOR HOLDING COMPANIES CLASSIFIED AS S.I.C.A.F.’S

According to the new definitions of undertakings for collective investment (“U.C.I.’s”) and alternative investment fund managers (“A.I.F.M.’s”) provided by Legislative Decree n. 44/2014 (the “A.I.F.M. Decree”), which implements Directive 2011/61/E.U. (the “A.I.F.M. Directive”), some Italian holding companies could be deemed to be S.I.C.A.F.’s and, therefore, be subject to the tax regime applicable to U.C.I.’s. It should be noted that such treatment would be an exception to the general rule, according to which holding companies do not fall within the new definitions of U.C.I. and A.I.F.M.

In particular, both the A.I.F.M. Decree and the A.I.F.M. Directive provide that a holding company is outside the scope of the respective legislation if it is a company that has shareholdings in one or more other companies, the commercial purpose of which is to carry out a business strategy or strategies through its subsidiaries, associated companies, or participations in order to contribute to their long-term value, and which is either a company: (i) operating on its own account and whose shares are admitted to trading on a regulated market in the E.U.; or (ii) not established for the main purpose of generating returns for its investors by means of divestment of its subsidiaries or associated companies, as evidenced in its annual report or other official documents.<sup>70</sup>

Conversely, it seems that holding companies other than those described above could fall within the scope of the A.I.F.M. Decree and A.I.F.M. Directive and, in particular, within the definition of a S.I.C.A.F. (*i.e.*, a closed-end U.C.I. in the form of a joint stock company with fixed capital and a registered office and general management in Italy, its exclusive purpose being the collective investment of assets obtained by the offer of its own shares and other financial instruments of equity held by the same). If a holding company is deemed to be a S.I.C.A.F., it is subject to the tax regime applicable to U.C.I.’s, which is unlike the tax regime for holding companies described above.

In principle, a U.C.I. is considered liable for tax in Italy as if it were a normal joint stock company – but it is exempt from income tax, and as a consequence, the group

<sup>69</sup> *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam*, Case C-371/10, [2011] E.C.R. I-12273; *European Commission v. Portuguese Republic*, Case C-38/10, [2012] E.C.R. I\_\_\_\_ (delivered September 6, 2012).

<sup>70</sup> Article 4 of the A.I.F.M. Decree and A.I.F.M. Directive.

“While the S.I.C.A.F. itself is exempted from income tax, the profits arising from investments carried out by such an entity are taxed at the investors’ level through the application of a withholding tax.”

tax consolidation regime mentioned above is not permitted.

While the S.I.C.A.F. itself is exempted from income tax, the profits arising from investments carried out by such an entity are taxed at the investors' level through the application of a withholding tax. The withholding tax rate will depend on tax residence and subjective status of the investor. Hence, certain tax regimes described above, such as the dividend exemption or the participation exemption, are not applicable.<sup>71</sup>

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<sup>71</sup> Therefore, in the absence of specific transitional rules, the transformation of a holding company that has the legal form of a corporate entity into a S.I.C.A.F. could lead to taxation of any unrealized gains on its assets, since such an operation could be considered, from a tax point of view, to be a transformation of a corporation into a “non-commercial” entity.

# GERMANY

## Author

Wolf-Georg von Rechenberg  
CMS Hasche Sigle  
Berlin, Germany

## INTRODUCTION

In the past few years, several steps have been taken to make Germany a more attractive jurisdiction for holding companies, especially within the E.U. At the same time, efforts have been made to prevent multinational businesses from using international financing structures which treat interest paid to shareholders as business expenses in Germany while leaving the profits of business operations taxable in tax havens.

In determining Germany's advantages as an investment location, judgment should not rest solely on the tax rate: whereas the base corporate tax rate of 15% seems to be very attractive, the effective tax rate can range to about 30% due to the added trade tax burden. Nevertheless, preferred tax treatment for dividends received from other companies and capital gains from the sale of participations in addition to an exemption from dividend withholding tax for dividends paid to companies resident in E.U. Member States has ultimately created a competitive tax environment for investments in Germany. This is particularly interesting given that the German economy has not suffered from the worldwide financial crisis to the same extent as other European economies, making Germany an attractive location for holding companies and active investments. In addition, Germany has one of the largest tax treaty networks, with only a few countries, such as Brazil and Saudi Arabia, being excluded.

## GENERAL TAXATION OF GERMAN CORPORATE ENTITIES

A German holding company is subject to both corporate tax and trade tax. The regular corporate tax rate is 15% (plus a 5.5% solidarity surcharge on the corporate tax liability). On top of the corporate tax, trade tax must be paid by most companies. Trade tax is a municipal tax and the rate is determined by each municipality, which leads to an effective trade tax rate between 7% and 17%, with the average being 14%. Therefore, the effective tax burden for a corporate entity is about 30%. It should be mentioned that there is special trade tax treatment for pure real estate companies. Under certain circumstances, these companies are fully exempt from trade tax. This makes Germany a very attractive place for real estate holding companies no matter where in Germany the real estate is located.

The taxable base for corporate tax, solidarity surcharge, and trade tax is the income defined through the tax balance sheet, with certain adjustments for income taxable as defined by the Trade Tax Act.

# GENERAL PARTICIPATION AND DIVIDEND EXEMPTION

## **Background**

In Germany, corporate tax is levied on the profit of a corporation as computed in the company's commercial balance sheet and adjusted for tax purposes. There is no difference in the treatment of distributed or retained profits.

Dividends and capital gains received from corporations within or outside of Germany are essentially exempt from German corporate tax, provided that, in the case of dividends, the corporation holds at least 10% of the corporation making the dividend payment. However, 5% of these dividends or capital gains are treated as nondeductible expenses, resulting in an effective tax of less than 2% on these profits. To avoid the use of hybrid financing structures, this beneficial treatment has 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>1</sup> The participation exemption in partnership structures also applies for trade tax purposes.

However, there are certain exceptions with regard to this tax-free treatment, the most important of which are as follows:

- The exemption does not apply when a tax-deductible write-down of the shares has been carried out in the past and has not been reversed by the time of sale.<sup>2</sup>

<sup>1</sup> *Körperschaftsteuergesetz* ("KStG," or the German Corporation Tax Act), §8b, ¶6.

<sup>2</sup> *Id.*, §8b, ¶2, sent. 4.

*"German economy has not suffered from the worldwide financial crisis to the same extent as other European economies."*

- 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>3</sup> For corporate tax purposes, there is no holding period. However, the dividend exemption applies only if the corporation holds a minimum participation of 10%.<sup>4</sup> Below that threshold, the entire dividend payment is subject to tax at a rate of about 30%.

The dividend exemption also applies for trade tax purposes, if a participation of at least 15% has been held at the beginning of the tax year. In the case of foreign dividends received, a participation of at least 15% must be held for an uninterrupted period since the beginning of the tax year and the foreign company must pass an activity test. For participations in E.U. subsidiaries, a participation of 10% qualifies for the dividend exemption and no activity test is required.

Similar to the 95% participation exemption, the dividend exemption is limited to 95% of the dividend received, as 5% of all dividends received are deemed to be non-deductible expenses. In principle, this applies regardless of the amount of effective

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<sup>3</sup> *Id.*, §8b, ¶1.

<sup>4</sup> *Id.*, §8b, ¶4.

business expenses related to the dividend. The hybrid mismatch rule applies as explained above under **Background**.

If the entity receiving the dividend has a participation of less than 10% in the paying entity, the dividends received do not qualify for the exemption and are not deemed to be 5% nondeductible.

### **Financing Expenses**

Despite the capital gains and dividend exemption, financing costs related to the acquisition of shares are, in principle, fully deductible for corporate tax purposes, within the limitations of the earning stripping rules (see **Earnings Stripping Rules** below). This is an exception to the general rule of German tax law which provides that business expenses incurred in relation to tax-exempt income (*i.e.*, dividends or capital gains) are not tax deductible.<sup>5</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 there under

The additional deductions include

- 1.2% of 140% of the assessed value (“*Einheitswert*”) of real property;
- the distributive share of profits from an investment in a domestic or foreign partnership;
- dividends from a domestic corporation in which the Taxpayer holds an interest of at least 15% since the beginning of the tax year; and
- dividends from a foreign corporation in which the taxpayer holds an interest of at least 15% (10% in a case where the E.U. Parent-Subsidiary Directive

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<sup>5</sup> *Einkommensteuergesetz* (“EStG” or the German Income Tax Act), §3c, ¶1.

is applicable) since the beginning of the tax year, provided this corporation (almost exclusively) generates active income.<sup>6</sup>

## EARNINGS STRIPPING RULES

### General Concept

With the 2008 Business Tax Reform Act, earnings stripping rules were introduced into the German income tax law, replacing the former thin capitalization rules.<sup>7</sup> The earnings stripping rules apply in general to all types of debt financing for sole entrepreneurs, partnerships, and corporations. The scope of the rules is far broader than the former thin capitalization rules, as any third-party debt financing (whether or not there is back-to-back financing) will be included. Interest expense is completely deductible from the tax base only to the extent the taxpayer earns positive interest income in the corresponding financial year. Interest expense in excess of interest revenue (net interest expense) is deductible only up to 30% of tax E.B.I.T.D.A. (interest deduction ceiling).

Tax E.B.I.T.D.A. is defined as the taxable profit before the application of the interest deduction ceiling, increased by interest expenses and by fiscal depreciation and amortization, and reduced by interest earnings.

For purposes of the earnings stripping rules, the controlling company and the controlled companies of a tax group are treated as a single entity. Thus, the earnings stripping rules are not applicable at the level of the controlled company. The interest expense and interest revenue of the controlled company and the controlling company are aggregated.

Nondeductible interest expense in a considered period may be carried forward (known as “interest carryforward”). As is the case with the year in which interest carryforward arises, when carried to a subsequent year, the interest carryforward is not taken into account in determining the tax E.B.I.T.D.A. They simply may be claimed as deductions to the extent the net interest expense in the subsequent year is less than the 30% of E.B.I.T.D.A. for that year. In a similar way, any tax E.B.I.T.D.A. amount that is not consumed by interest expense for the purpose of the earnings stripping rules in a particular year may also be carried forward (known as “E.B.I.T.D.A. carryforward”) to increase the ceiling in the carryforward year.

### Exemptions

A *de minimis* rule applies to the earning stripping limitations on the deductibility of net interest expense. The earnings stripping rules apply only when interest expense exceeds positive interest income by at least €3 million (the “tax threshold”). Thus, small- and medium-sized business enterprises are generally exempt from the scope of the earnings stripping rules, provided the tax threshold for a year is not reached or exceeded.

The earnings stripping rules also do not apply to businesses that are not members of a controlled group. A business is regarded as part of a controlled group if it is or



<sup>6</sup> The active business requirement is not applicable to companies resident in an E.U. Member State.

<sup>7</sup> EStG, §4h; KStG, §8a.

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's equity ratio – the percentage of balance sheet assets funded by equity – is equal to or greater than the equity ratio of the controlled group, the earnings stripping rules do not apply. There is a 2% safety cushion for the equity ratio of the business in question. Consequently, the escape clause may be met when the equity ratio of the entity is 48% and the equity ratio of the controlled group is 50%. As indicated above, the calculation of the equity percentage of the business must be based on the values of the assets and liabilities as reflected in the consolidated financial statements.

The exemption for non-controlled corporations and the escape clause apply only if the corporation establishes that remuneration on shareholder debt accounts does not exceed 10% of the net interest expense of the relevant entity.<sup>8</sup> Shareholder debt is defined as debt that is granted by a substantial shareholder,<sup>9</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 deduction limit on license payments.<sup>10</sup> This applies to expenses arising from the year 2018 onwards.

The new section restricts the deduction of royalties and similar payments made to related parties if, in the other country, the payments are (i) subject to a preferential tax regime, such as an I.P. Box regime, and the rules in the other country are not compliant with the O.E.C.D. nexus approach presented in its B.E.P.S. Report on Action Item 5, and (ii) subject to an effective tax rate of less than 25%. A safe harbor exists for royalty payments to a company that carries on substantial research and development activities.

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

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<sup>8</sup> KStG, §8a, ¶2.

<sup>9</sup> Shareholder of more than 25%.

<sup>10</sup> EStG, §4j.

*“There is a deduction limit on license payments. This applies to expenses arising from the year 2018 onwards.”*

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>11</sup> According to these rules, up to €1 million in losses may be deducted in full in any single subsequent year. In addition, 60% of the amount exceeding €1 million 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.

Losses from one business year of up to €1 million can be carried back to the previous year. The remaining losses are carried forward and can be used in future years within the limits described above (minimum taxation rule).

A loss carryover may be reduced or eliminated if a change in ownership exists in the company incurring the loss. According to the rules in Germany’s Corporation Tax Act (“*Körperschaftsteuergesetz*” or “KStG”):

- Losses are cancelled in full if more than 50% of the shares of a corporation are transferred within a period of five years.
- Losses are cancelled in proportion to the percentage of shares transferred if more than 25% but less than 50% of the shares in a corporation are transferred within a period of five years.

A special rule was incorporated into §8c KStG in order to facilitate the preservation of losses during the takeover of a crisis-stricken company. New legislation in §8d KStG has relaxed 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.

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>12</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

<sup>11</sup> *Id.*, §10b.

<sup>12</sup> KStG, §8c.

the losses cannot be used otherwise.<sup>13</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.

## 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>14</sup> The C.F.C. rules apply if

- more than 50% of the share capital or voting rights in the foreign corporation are held by taxpayers who are subject to unlimited tax liability in Germany,
- the foreign corporation generates passive income, and
- the foreign corporation is subject to low taxation (*i.e.*, its effective tax burden as determined according to German tax principles is below 25%).

Passive income is defined as income that is not explicitly classified as active under the C.F.C. regulations. Classified active income includes income from manufacturing, trading, the provision of services, and some forms of licensing and renting, with the exception of certain structures designed to reallocate taxable income from Germany to a tax haven. Dividends, constructive dividends, and, in principle, capital gains are active income, as well. The classification of capital gains as active income depends on the activity of the target company sold by the C.F.C.

Special rules apply for companies generating investment type income. Investment type income derived by a C.F.C. can be apportioned to a German shareholder owning directly or indirectly at least 1% of the shares of the C.F.C. Investment type income is income generated from liquid assets such as cash, securities, and participations. The C.F.C. rules also apply where the ownership interest is less than 1% if the foreign company derives gross revenue that exclusively or almost exclusively gives rise to investment type income, unless the principal class of the foreign company's stock is actively traded in significant volume on a recognized stock exchange.

If the aforementioned conditions are fulfilled, passive income as determined under German tax legislation is apportioned to all German-resident individual and corporate shareholders. The apportioned income is treated as a profit distribution received in the year following the year in which it is realized by the C.F.C. The German shareholder does not benefit from applicable treaty provisions, and the general dividend exemption does not apply.<sup>15</sup>

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<sup>13</sup> *Id.*, §8d.

<sup>14</sup> *Außensteuergesetz* ("AStG" or the German Law on Taxation in Foreign Relations), §7.

<sup>15</sup> Foreign Relations Taxation Act, §10, ¶2, sent. 3 ("F.R.T.A.").

*“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.”*

Losses of the C.F.C. are not deductible by the German shareholder, but they may be carried forward or backward against profits of the C.F.C. to offset C.F.C. dividend income of the shareholder.

An exemption from the C.F.C. rules applies for a C.F.C. that maintains its registered office or place of management in a member country of the E.U. or E.E.A., provided the company carries on genuine economic activities in that country.<sup>16</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 European Court of Justice in the *Cadbury Schweppes* decision. Only such income that is attributable to the genuine economic activity and that is derived by that particular activity is exempt from the C.F.C. rules, and only for amounts that do not exceed arm’s length consideration.

## 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>17</sup>

### Treaty Network

Germany has an extensive income tax treaty network with almost 100 income tax treaties in force and effect as of April 2018.

Albania	Algeria	Argentina	Armenia
Australia	Austria	Azerbaijan	Bangladesh
Belarus	Belgium	Bolivia	Bosnia & Herzegovina
Bulgaria	Canada	China	Costa Rica
Croatia	Cyprus	Czech Republic	Denmark
Ecuador	Egypt	Estonia	Finland
France	Georgia	Greece	Ghana
Hungary	Iceland	India	Indonesia
Iran	Ireland	Israel	Italy
Ivory Coast	Jamaica	Japan	Jersey
Kazakhstan	Kenya	Kosovo	Kuwait
Kyrgyzstan	Latvia	Liberia	Liechtenstein
Lithuania	Luxembourg	Macedonia	Malaysia

<sup>16</sup> *Id.*, §8, ¶2.

<sup>17</sup> EStG, §43b, ¶2.

Malta	Mauritius	Mexico	Moldova
Mongolia	Montenegro	Morocco	Namibia
Netherlands	New Zealand	Norway	Pakistan
Philippines	Poland	Portugal	Romania
Russia	Serbia	Singapore	Slovakia
Slovenia	South Africa	South Korea	Spain
Sri Lanka	Sweden	Switzerland	Syria
Taiwan	Tajikistan	Thailand	Trinidad & Tobago
Tunisia	Turkey	Turkmenistan	Ukraine
United Arab Emirates	United Kingdom	United States	Uruguay
Uzbekistan	Venezuela	Vietnam	Zambia
Zimbabwe			

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

### **Anti-Abuse Provisions**

Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies.<sup>18</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.

## **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.

<sup>18</sup> *Id.*, §50d, ¶3.

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 formal constructive dividend even if the transaction is carried out at arm's length.

The arm's length principle is also applicable for any transaction with a permanent establishment.

### **Transfer of Functions**

Provisions on the transfer of functions are included in the transfer pricing legislation. A function is transferred if it is relocated abroad with the associated opportunities and risks, including the assets and other benefits, also transferred or otherwise provided.

In principle, a payment in consideration of the transfer shall be calculated for the transfer as a whole. The calculation of this payment is to be based on the impact of the function shifted on the profits of the transferring and receiving companies. The administration 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.

*“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.”*

## GERMAN INVESTMENT LAW TAXATION

Until now, investment funds have been exempt from taxation and only individual investors were subject to tax, even if gains were not distributed. Beginning with the year 2018, the taxation of investment funds is fundamentally reformed. 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.

*“All funds are taxed according to the same scheme: on the basis of an annual lump sum.”*

# CYPRUS

## Author

Nairy Der Arakelian-Merheje  
Der Arakelian-Merheje LLC  
Nicosia, Malta

## 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

*“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.”*

company documents relating to the management, control, and administrative functions of the company in Cyprus. All transactions are scrutinized very carefully, including the qualifications of the directors.

- The majority of the directors of the company are tax-resident in Cyprus and exercise their duties from Cyprus.
- A physical (administrative) office is maintained in Cyprus, from which actual management and control of the business is exercised.
- Hard copies of commercial documentation (e.g., agreements, invoices, etc.) are stored in the company's office facilities in Cyprus.
- Accounting records of the company are prepared and kept in Cyprus.
- Bank accounts of the company are operated from Cyprus, even if the accounts are maintained with banks established outside Cyprus.

#### 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 he or she was 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.

### **Permanent Establishments**

In Cypriot income tax law, the definition of a permanent establishment follows the definition found in Article 5 of the O.E.C.D. model convention.

Profits from the activities of a permanent establishment outside of Cyprus are exempt.

### **New Amendments Since July 2015**

As a general rule, residents of Cyprus are taxed on worldwide income. However, several important exceptions apply to this rule. They may be summarized as follows:

#### *Notional Interest Deduction on Equity*

##### Existing Provisions

Currently, interest paid is deducted while calculating the taxable income only when such interest is actually incurred on a loan or other credit facility obtained. The deductibility of the interest expense depends on whether the funds for which the interest is paid have been used to finance taxable operations of the company and to acquire assets considered to be used in the business.

Interest paid to finance intercompany loans is deductible, provided certain acceptable margins are maintained at the level of the Cypriot-resident company.

In practice, the use of back-to-back loans can create beneficial ownership issues with regards to the provisions of certain double tax treaties. However, back-to-back loans are being phased out and banks no longer remit such funds except between related companies.

It should be noted that interest paid on loans to finance the acquisition of investments is only allowed in the case of wholly-owned subsidiaries acquired after January 1, 2012.

##### New Provisions

Cyprus has introduced provisions to allow the notional deduction of interest in cases where investment is by way of equity instead of interest-bearing loans. Similar provisions have existed for years in other competing jurisdictions.

The main provisions of the law are as follows:

- A deemed interest deduction will be allowed on “new equity” funds introduced into a Cyprus-resident company and funds that are used for the business of the company.
- The deemed interest will be calculated on the basis of a “reference interest rate.” This rate is equal to the yield on the ten-year government bonds of the country where the new funds are invested, plus 3%, with the minimum rate being the yield on the ten-year government bonds of Cyprus, plus 3%.
- New equity means any equity funds introduced into the business after January 1, 2015, not including capitalization of reserves resulting from the evaluation of movable and immovable property.
- Equity includes both share capital and share premium (ordinary or preferred) to the extent that it has actually been paid up. The consideration for the issue of the shares can also be assets (other than cash), in which case the consideration cannot exceed the market value of the assets contributed. Other forms of equity contribution are not acceptable.
- The notional interest to be deducted cannot exceed 80% of the taxable income of the company for the year before the deduction of this notional interest. Therefore, in years with a tax loss, such a benefit will not be applied.
- The deductibility of the deemed interest will be subject to the same rules as actual interest paid, *i.e.*, it will be tax deductible only if it relates to assets used in the business.
- Claiming of the notional interest is at the discretion of the taxpayer on a yearly basis.

As the deemed interest need not be paid to be deductible, it should be exempt from 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 new incentive for deemed interest deductions would result in various benefits and eliminate potential issues. These include the following scenarios:

- Higher share capital, rather than large loans, would be more beneficial from a business operational perspective.
- Under the participation exemption rules, it may benefit the parent company to receive dividends rather than interest, which would be taxable.

*“Cyprus has introduced provisions to allow the notional deduction of interest in cases where investment is by way of equity instead of interest-bearing loans.”*

- For example, rather than lending its own funds to a subsidiary, a parent company (“Company A”) may make an equity contribution to its subsidiary (“Company B”). In the case of an equity contribution, Company A will not have taxable interest income, whereas Company B will get a deemed interest deduction. If Company B distributes the profits (without any actual interest cost) to Company A, then dividends received by Company A could be exempt from taxation.
- In cases where funds are used on back-to-back loans, beneficial ownership issues for interest received under an income tax treaty are subject to strict scrutiny. As a result, back-to-back loans are being phased out.

To illustrate, assume Company A, a resident of Country A, borrows funds from Company B, a resident of Country B. Company A lends the same funds to Company C, a resident of Country C. In this case, the tax authorities of Country C may refuse tax treaty benefits when Company C makes payments to Company A because Company A is obligated to pay to Company B all or most of the interest received. In these circumstances, Company A is not the ultimate beneficial owner of the interest because of its own obligation to pay the amount received to Company B.

Compare the foregoing result with a fact pattern in which Company A issues capital stock to Company B in return for a capital contribution. Company A then lends funds to Company C. Since Company A has no legal or contractual obligation to use the interest received from Company C to pay interest to Company B, no beneficial ownership issues should arise in Country C regarding payments to Company A.

### **Expansion of the Definition of the Republic of Cyprus**

The law has been amended so that the definition of the term “Republic of Cyprus” now includes, specifically and clearly, the territorial sea, the contiguous zone, the exclusive economic zone, and the continental shelf of Cyprus.

The law has also been amended so that the definition of a permanent establishment now includes all activities for the exploration and exploitation of the seabed in the exclusive economic zone and services related to such exploration or exploitation activities.

Gross income earned from sources within Cyprus (including those mentioned above) by a person who is not a tax resident of Cyprus or who does not have a permanent establishment in Cyprus that provides services listed in **Basic Concept** above would be subject to tax at the rate of 5%.

This provision applies as of January 1, 2016.

### **Tax Losses Group Relief**

Under the current provisions of the law, group loss relief can only be given for losses incurred by Cyprus-resident companies. This means that losses incurred by a member of a group of companies can only be surrendered to another member of the same group, provided that both companies are tax residents of Cyprus.

In order to align the Cypriot tax law with the decision by the E.C.J. in the *Marks & Spencer* case, the law has been amended so that a subsidiary company that is tax resident in another E.U. Member State can surrender its taxable losses to another

group member that is tax resident in Cyprus, provided the subsidiary has exhausted all the means of surrendering or carrying forward the losses in its Member State of residence or to any intermediate holding company.

When surrendering tax losses, as above, taxable losses must be calculated on the basis of Cypriot tax law.

The law has also been amended to allow, for the purposes of determining whether two companies are members of the same group, the interposition of holding companies established in (i) another E.U. Member State, (ii) a state with which Cyprus has concluded a double tax treaty, or (iii) a state that has signed the O.E.C.D. multilateral convention for exchange of information.

These provisions apply as of the tax year 2015.

### **Reorganization of Companies and Anti-Avoidance Provisions**

The E.U. directive on mergers, acquisitions, and spinoffs has been implemented in Cyprus. Consequently, mergers, divisions, transfers of assets, and exchanges of shares can be effected without the imposition of income tax. In addition, the losses of the target company may be transferred to the acquiring company provided that both companies are Cypriot tax residents and certain conditions are met.

The scope of the exemption is broad. Gains resulting from the exchange of shares in a merger or reorganization will not be subject to tax. When immovable property is included in the reorganization, capital gains on the transfer will not be subject to capital gains tax. No land transfer fees will be payable on the transfer of immovable property, except if the property is located in Cyprus.

Several anti-avoidance provisions have also been introduced allowing the Tax Commissioner the right to refuse to accept tax-free reorganizations if the Commissioner is not satisfied that real commercial or financial reasons exist for the reorganization. In other words, the main purpose or one of the main purposes of the reorganization is the reduction, avoidance, or deferment of payment of taxes and that fact taints the tax-free nature of the transaction.

The Commissioner has the right to impose conditions on the number of shares which can be issued as part of the reorganization and the period for which such shares should be held (not more than three years).

However, such restrictions cannot apply in the case of publicly-listed companies and transfers of shares as a result of succession.

These provisions apply as of January 1, 2016.

### **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 company has intercompany loans originating out of borrowed funds
- For other intercompany transactions, performing a functional analysis that is compliant with international standards as part of an annual transfer pricing study
- 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 with 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 effective management and control of daily operations, and overall management and control through the oversight of an active board of directors in Cyprus. General intercompany transfer pricing rules are discussed in **Arm's Length Transfer Pricing** below.

### **Specific Income Tax Benefits**

Certain types of income that may be subject to favorable tax treatments are discussed in the following sections.

#### **Shipping and Aircraft Businesses**

Under the reciprocal exemption provisions, in the case of a shipping and aircraft business, profits or benefits arising from the business of operating ships or aircraft are exempt from tax in Cyprus if they are carried on by a person who is not a resident of Cyprus, provided that the Cypriot Minister of Finance is satisfied that there is an equivalent exemption from income tax granted by the country in which such person is resident to persons resident in Cyprus who carry similar business in that other country.

The income of ship-owning companies is tax-exempt, as well as V.A.T.-exempt.

Ship management income is subject to tax under the new tonnage tax legislation, which reduces taxation to very low effective rates. However, specific conditions must be met for these rates to be implemented, otherwise the 12.5% corporate rate applies.

#### **Intellectual Property**

Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the effective rate of 5% of the amounts paid. A similar

rate of tax is imposed on film rental income derived by a nonresident. However, the E.U. Royalties Directive applies in the case of film rentals.

Royalties granted for the use of I.P. rights outside Cyprus are not subject to withholding tax.

Additionally, a new I.P. Box regime was approved by Law 110 (i) of 2016, published on October 27, 2016, and by Regulations 336/2016, dated November 18, 2016. Circular 2017/4 was issued on March 22, 2017 to address the issue of embedded income.

The I.P. Box allows for an exemption from taxation of 80% of the gross income from use of intangible assets. The key provisions of the regime are discussed below.

### Qualifying Intangible Assets

A “qualifying intangible asset” is an asset that was acquired, developed, or exploited by a person in furtherance of its business (excluding intellectual property associated with marketing). The I.P. must be the result of research and development activities. A qualifying intangible asset includes intangible assets for which only economic ownership exists, such as

- patents,
- computer software, and
- certain specified assets.

### Qualifying Profits

“Qualifying income” means the proportion of the overall income corresponding to the fraction of the qualifying expenditure plus the uplift expenditure, over the total expenditure incurred for the qualifying intangible asset.

Income includes

- royalties for the use of the asset,
- amounts received from insurance or as compensation,
- gains from the sale of the intangible asset, and
- embedded 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

*“Cyprus income tax law now imposes stricter limitations on the ability of a corporation to deduct expenses when calculating net annual taxable income.”*

- 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 in **Special Contribution for the Defense of the Republic** below.

For corporations, gains from trading in stocks, shares, and securities are generally exempt from income tax. The definition of securities has recently been substantially expanded to grant a broader exemption for Cypriot holding companies that deal in securities.

Pursuant to I.T.L. §8(22), the following instruments are considered securities for the purposes of the exempt capital gains rules:

- Short positions in titles
- Rights of claim on bonds and debentures
- Options on titles
- Founders shares
- Units in open-end and closed-end collective schemes
- Index shares or index bonds
- Futures/forwards on titles
- Preference shares
- Swaps on titles
- Repurchase agreements or repos on titles
- Depositary receipts on titles
- Participations in companies
- Shares in L.L.C.'s registered in the U.S.

Dividends paid into a Cypriot holding company are exempt from income tax, and no withholding tax is payable when dividends are paid by a Cypriot holding company to its nonresident shareholders. The combination of an exemption for share gains and

an absence of tax on dividend income received or paid by a Cypriot holding company likely accounts for the no-table increase in the number of nonresident-owned holding companies in Cyprus since its accession to the E.U. However, in light of changes to the P.S.D., the use of Cyprus as a holding company jurisdiction for other corporations in the E.U. 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 because 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 there is no bilateral agreement or double tax treaty in force.

### **Loan Interest**

The 9% notional interest on loans or other financial facilities has been eliminated, but if Cyprus-resident individuals are the recipients, such loans are considered benefits and are taxed as personal income. For corporate shareholders, the arm's length principle will now be applicable, and much lower interest rates are accepted. Back-to-back loans do not generate notional interest and are now being phased out.

Whenever a loan or other financial instrument is provided to individual shareholders or directors of a company (or to their first- or second-degree relatives), the recipient is deemed to receive a benefit of 9% *per annum*, calculated on the outstanding balance of the loan on a monthly basis. This benefit is assessed in the hands of both resident and nonresident directors and shareholders. In the case of nonresident directors and shareholders, the benefit should be deemed to arise only in relation to actual days spent in Cyprus (on a *pro rata* basis).

Also, no restriction is imposed on interest with respect to the acquisition of shares of a directly or indirectly wholly-owned subsidiary company, provided that the subsidiary does not hold assets that are not used in the performance of its business.

Losses may be offset within a group of companies, even if derived in the year in which an entity is incorporated.

In order to encourage investment, factories and machinery acquired during the years 2012, 2013, and 2014 are permitted a 20% depreciation allowance rather than the standard allowance of 10%.

Payroll costs and contributions are not tax deductible if contributions to the Social Insurance Fund, Redundancy Fund, Human Resources Development Fund, Social Cohesion Fund, Pension Fund, and Provident Fund are not paid in the year in which they are due.

### **Anti-Avoidance Provisions for Hybrid Instruments and Artificial Transactions for Dividends**

Under current law, dividends are exempt from income tax but are subject to defense tax for tax-resident Cypriot individuals and, in a number of cases, for companies.

In some cases, a payment received by a Cypriot company from a company located outside of Cyprus may be considered a dividend in Cyprus, while also being treated as a tax-deductible expense in the country of the company making the payment. These are known as “hybrid instruments.”

*“Interest received in the ordinary course of business is exempt from the Special Defense Levy.”*

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.

The Special Defense Levy on interest income from investments has now increased from 15% to 30%, but this only applies to residents of Cyprus. Furthermore, interest received in the ordinary course of business is exempt from the Special Defense Levy.

Nonresident and tax resident but non-domiciled shareholders of Cyprus-resident companies are not subject to the Special Defense Levy.

Dividends paid from one Cyprus-resident company to another are exempt. Dividends received by a resident company from a nonresident are also exempt if (i) the investment income of the nonresident company is less than 50% of its total income, or (ii) the foreign tax burden is not substantially lower than the tax burden in Cyprus. This condition is met if either alternative is met. The term “substantially lower” is not defined within Cypriot law and is, therefore, left to the discretion of the tax authorities.

New amendments impose much higher and stricter penalties for noncompliance with the provisions of the Special Contribution for the Defense of the Republic.

## OTHER TAXES

### **Capital Gains Tax**

Capital gains tax is not applicable to profits earned from the sale of securities but is applicable to real estate sales within Cyprus.

#### **New Amendment – Capital Gains from the Sale of Shares in a Property Company**

Currently, capital gains tax is charged on the disposal of immovable property located in Cyprus or on the disposal of shares of companies that directly own immovable property located in Cyprus.

Under the new legislation, the scope of capital gains tax is expanded. Consequently, gains from the sale of shares in a company that indirectly owns immovable property in Cyprus, by directly or indirectly holding of shares in a company that owns such property, will also be subject to capital gains tax. However, this tax will only apply if the value of the immovable property represents more than 50% of the value of the assets of the company whose shares are sold.

The change in the legislation can be illustrated as follows:

- Company A owns shares of Company B, which owns the shares of Company C, which in turn owns immovable property located in Cyprus.
- Currently, capital gains tax will arise if
  - Company C sells the immovable property, or
  - Company B sells the shares of Company C.
- Under the new legislation, capital gains tax will also arise if Company A sells the shares Company B.

In the case of the sale of shares of a company owning immovable property, the gain to be taxed will be calculated only based on the market value of the immovable property, which is held directly or indirectly.

#### **Trading Gains from the Sale of Shares of Property Companies**

Currently, if an entity is engaged in the sale of shares of companies such that the transactions are considered to be of a trading nature, any gains from the sale of such shares are exempt from income tax pursuant to the provisions of Cypriot income tax laws. Since these gains are not within the scope of capital gains tax law, the gains are tax-free, even if the shares being sold relate to a company that owns immovable property located in Cyprus.

Under the new legislation, these gains would remain exempt from income tax but would now be subject to capital gains tax.

#### **Transactions Between Related Parties**

In the case of the sale of property between related persons, the Tax Commissioner will have the right to replace the sale price declared by the parties concerned with the market value of the property sold, if, in his opinion, the selling price declared is lower than the market value.



## **Inheritance and Estate Taxes**

There are no such taxes on shares held in a Cypriot company.

## **Thin Capitalization Rules**

Cypriot tax law does not contain specific thin capitalization or transfer pricing rules. Nonetheless, transaction values in related-party transactions should be based on the “arm’s length principle.”

## **ARM’S LENGTH TRANSFER PRICING**

Section 33 of the tax law provides specific rules to address business structures where

- i. a Cyprus business participates directly or indirectly in the management, control, or capital of a business of another person, or the same persons participate directly or indirectly in the management, control, or capital of two or more businesses; and
- ii. commercial or financial relations between said businesses differ substantially from those that would exist between independent businesses.

Under these circumstances, any profits that would have accrued to one of the businesses in absence of these special conditions may be included in the profits of that business and be taxed accordingly.

This provision allows the Inland Revenue Department to adjust the profits of a resident company or other person for income tax purposes where it is of the opinion that, because of the special relationship between the Cyprus-resident person and the other party to a transaction, the Cyprus profits have been understated.

## **TAX REGISTRATION PROVISIONS**

Regarding the obligation to register for a Tax Identification Code (“T.I.C.”) in Cyprus, although a company should register itself with the Cyprus Tax Authorities, a legal framework did not previously exist for such registration or for noncompliance penalties.

Now, a company is obliged to submit the relevant return and obtain a T.I.C. within 60 days of the date of its incorporation. Failure to comply will now result in heavy fines.

## **EXCHANGE OF INFORMATION AND BANK CONFIDENTIALITY RULES**

Cyprus is one of the “Early Adopters” of the Common Reporting Standard (“C.R.S.”). Consequently, a decree based on the income tax laws was enacted in December 2015 and was amended in May 2016. The amended decree imposes the obligation upon Cypriot financial institutions to effect an automatic exchange of information through the Central Bank of Cyprus with all other jurisdictions that are signatories of the C.R.S. convention. Banks have already introduced new forms, which include the requirement for the provision of the tax residence I.D. numbers of ultimate

beneficial owners (“U.B.O.’s”).

Cyprus is a signatory of the O.E.C.D. Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This is a multilateral agreement to exchange information and provide assistance on the basis of inquiries from one signatory state to another.

Consequently, if and when the Cyprus Tax Authorities receive an inquiry from the tax authority of another signatory state, Cyprus is obliged in practice to provide such information without resorting to the procedure described below, so long as certain conditions of the local legislation are satisfied. Fishing expeditions will not be permitted.

For inquiries not related to the C.R.S., the Director of Inland Revenue (the “Director”) retains the right to request that a bank provide information it possesses in relation to any existing or closed bank account of a person under investigation within a period of seven years preceding the date of the request. Prior to making such a request, the Director must obtain written consent from the Attorney General (“A.G.”) and furnish the person under investigation with a relevant written notice.

The Director must inform the A.G. of the tax purpose and the reasons for which the information is requested. In order to obtain consent from the A.G., the Director should apply directly to the A.G. and furnish both the A.G. and the bank with the following:

- 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

Furthermore, the Director must inform the person under investigation of the written consent, or the refusal of such consent, by the A.G. as soon as this information is made available.

### **Provision of Information by Civil Servants**

The confidentiality bar on civil servants is now removed, and civil servants are now under the obligation to reveal to the tax authorities, upon request, any information they may have on taxpayers.

### **Bookkeeping and Field Audits**

Following the provision of a reasonable notice to the interested party during a field audit, the Director is entitled to enter and inspect any business premises, building premises, or rooms (during business hours), except residential dwellings, including any goods and documents found in them.

## MORE STRINGENT REQUIREMENTS FROM THE E.U. AND OTHER JURISDICTIONS

Various E.U. Member States and other jurisdictions now require more detailed explanations from clients using private Cypriot companies within their structures. Such disclosures include the length of time shares are held, copies of transaction documents, confirmation from the board of directors that the Cypriot company is managed and controlled in Cyprus, proof of the appropriate qualifications and experience of the directors, and evidence of an actual physical presence in Cyprus.

With planning, proper record keeping, and the adoption of rules regarding economic substance, corporate residents of Cyprus have successfully claimed treaty benefits from foreign tax authorities.

## DOUBLE TAX TREATIES

### 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.

Armenia	Austria	Azerbaijan	Bahrain
Barbados	Belarus	Belgium	Bosnia & Herzegovina
Bulgaria	Canada	China	Czech Republic
Denmark	Egypt	Estonia	Ethiopia
Finland	France	Georgia	Germany
Greece	Guernsey	Hungary	Iceland
India	Iran	Ireland	Italy
Jersey	Kuwait	Kyrgyzstan	Latvia
Lebanon	Lithuania	Luxembourg	Macedonia
Malta	Mauritius	Moldova	Montenegro
Norway	Poland	Portugal	Qatar
Romania	Russia	San Marino	Serbia
Seychelles	Singapore	Slovakia	Slovenia
South Africa	Spain	Sweden	Switzerland
Syria	Tajikistan	Thailand	Turkmenistan
Ukraine	United Arab Emirates	United Kingdom	United States
Uzbekistan			

### Cyprus U.K. Income Tax Treaty

A new double tax treaty between Cyprus and the U.K. will take 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 domestic tax law, the competent authorities shall take into account the following factors:

- Where the senior management of the company is carried out
- Where the meetings of the board of directors or equivalent body are held
- Where the company's headquarters are located
- 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. 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 in **Anti-Avoidance Provisions for Hybrid Instruments and Artificial Transactions for Dividends** above.

### **B.E.P.S. Action 3 (Effective C.F.C. Rules)**

Controlled foreign corporation (“C.F.C.”) rules do not currently exist in Cyprus.

### **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.

### **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 will be phased out in 2021.

With the introduction of the nexus approach, it will be difficult for many international businesses to continue to take advantage of the Cypriot I.P. Box regime beyond the expiration of the grandfather period at the end of the year 2021. For the benefit to extend further, the Cypriot government must develop an incentive program beyond the adoption of a low tax rate for I.P. Box companies. Implementation of B.E.P.S. Actions 5 will make Cyprus an ideal location for the internal development of intangibles.

### **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 principal purpose test 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 (see **Double Tax Treaties** above).

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 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 Reporting.

Every ultimate parent company of a multinational group of companies that is tax resident of Cyprus must submit a country-by-country report within 15 months of the end of its financial year.

The first report for the year 2016 must be submitted by June 30, 2018. The report must include the following information for each country (whether E.U. or non-E.U.) where the group is operating:

*“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.”*

- 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. will apply in cases where both states are party to the M.L.I. The M.L.I. will not apply where only one of the contracting states is a party to it.

It is anticipated that the effects of the M.L.I. will be felt by 2019. Each signatory country will have the opportunity to express its reservations to any provisions of found in the instrument.

# MALTA

Author  
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 and has been further refined by E.U. regulations and directives. The result is a unique body of pragmatic law with international application.

The Companies Act envisages three forms of commercial arrangements as vehicles for conducting business: the partnership *en nom collectif*, the partnership *en commandite*,<sup>1</sup> 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 its limited liability for business owners and separate juridical personality.

Generally, the limited liability company – whether private exempt or private non-exempt, single-member or public – is the vehicle for conducting any kind of business activity without territorial limitation.

In addition, new legislation allows for the increased use of the S.I.C.A.V. and the I.N.V.C.O. for companies undertaking the provision of investment services:

- S.I.C.A.V. incorporated cell companies and recognized incorporated cell companies have been used in connection with structuring multi-class or multi-fund professional investment funds.
- The insurance sector regularly uses the protected cell company and the incorporated cell company as vehicles to conduct insurance and reinsurance business.
- Securitization cell companies have become increasingly common.<sup>2</sup> 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

<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.”).

<sup>2</sup> The number of securitization vehicles (whether cellular or non-cellular) has increased from under ten in 2015 to 34 by the end of 2016. Regarding cells, eleven were created in 2016 compared to a single cell created in 2015. These numbers continued to increase steadily throughout 2017.

personality, which is vested in the securitization company, itself. All cells are managed and administered by the board of directors or by holders of special mandates to manage and administer the securitization transaction executed by a particular cell.

### **Capital Contribution Taxes**

A company is incorporated in accordance with the provisions of the Companies Act by registering its memorandum and articles of association with the Registry of Companies. Maltese law does not prescribe any capital taxes upon incorporation, but does provide for a company registration fee, payable on the basis of the authorized share capital of the company. The fee ranges from a minimum of €245 to a maximum of €2,250.<sup>3</sup>

In order to maintain corporate good standing, the directors of the company are obligated to submit an annual return in compliance with the Companies Act provisions. The return is filed on each anniversary of the company's incorporation. The annual return must be accompanied by an annual return fee, which ranges from €100 to €1,400, depending on the company's authorized share capital.<sup>4</sup>

### **Governance and Responsibilities**

The management of a Maltese company rests with its board of directors. Members of the board may be individuals or corporate entities. Directors are not required to be resident in Malta. However, companies engaging in licensed activities, such as the provision of investment services, the appointment of Maltese-resident directors is required by the Malta Financial Services Authority ("M.F.S.A.").

The M.F.S.A. has issued corporate governance guidelines with respect to the management of public companies, listed companies, investment companies, and collective investment schemes. The guidelines are intended to promote a desired standard for members sitting on the board of directors of such companies. For private companies, the guidelines represent best practices and are recommended for the management and administration of larger private companies.

The directors of a Maltese company are personally responsible for the company's compliance with Maltese tax law and are personally liable for taxes owed by the company. Although court decisions vary, the prevalent view is that all officers are obligated to ensure that the company is compliant with the Value Added Tax Act. Responsibility extends to all directors and officers of a company, including the company secretary and persons occupying managerial positions. Comparable liability is also imposed on the liquidator of a company.

Identical obligations are imposed upon the directors with regards to the registration of employment contracts and the fulfillment of monthly and annual social security compliance requirements.



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<sup>3</sup> Lower registration fees ranging between €100 and €1,900 are imposed if the incorporation documents are submitted electronically.

<sup>4</sup> Lower registration fees ranging between €85 and €1,200 are imposed if the annual return is submitted electronically.

## **Audit Requirements**

In Malta, the preparation of mandatory audited financial statements is regulated by the Companies Act, the Maltese Income Tax Acts, and the Accountancy Profession Act. Financial statements are prepared in accordance with the International Financial Reporting Standards or under Maltese Generally Accepted Accounting Principles, as permitted by the Accountancy Profession Act and subsidiary legislation issued thereunder focusing on small- and medium-sized enterprises (“S.M.E.’s”).

Generally, all companies are subject to a mandatory audit of their annual reports and financial statements. However, stand-alone “small companies”<sup>5</sup> and “small groups”<sup>6</sup> of companies are not required to have their financial statements audited, although the Income Tax Acts may require audited financial statements in specific circumstances.

As a rule, the Companies Act requires the preparation of consolidated accounts whenever a Maltese company is the parent of a subsidiary, regardless of where the registered offices or principal offices of the subsidiaries are located. Certain exemptions apply to (i) private exempt companies, and (ii) single-member companies.

## **Specific Industry Incentives**

The Maltese Aircraft Registry was launched in 2010, building on the success of the Maltese Shipping Registry. Favorable rules exist with regards to income tax, tonnage tax, and V.A.T. for yacht-leasing operations, short-term yacht chartering, and aircraft-leasing arrangements.

Specific fiscal incentives launched by the Maltese government in various business sectors include tax exemptions for royalty income derived from the exploitation of patents, copyrights, and trademarks registered in the name of a Maltese-resident company. The exemption for royalty companies is part of a government program to transform Malta into an intellectual property hub. The exemption applies to gaming companies operating from a base in Malta.

Malta provides fiscal incentives to individuals who relocate to Malta for the purposes of employment under a qualifying contract in eligible offices.<sup>7</sup> This includes a 15%

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<sup>5</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>6</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>7</sup> Pursuant to the Highly Qualified Persons Rules (Subsidiary Legislation 123.126), qualifying employment includes employment with companies licensed and/or recognized by the competent authority or with undertakings holding an air operators’ certificate issued by the competent authority such as Chief Executive Officer, Chief Risk Officer (including Fraud and Investigations Officer), Chief Financial Officer, Chief Operations Officer (including Aviation

*“Favorable rules exist with regards to income tax, tonnage tax, and V.A.T. for yacht-leasing operations, short-term yacht chartering, and aircraft-leasing arrangements.”*

flat rate taxation for income derived from a qualifying contract.

Through Malta Enterprise, fiscal and business assistance is provided to businesses that establish factories on Maltese territory for production activities in sector-specific industries and for research and development.

Malta is a center for international credit institutions that operate as limited liability companies registered under the provisions of the Companies Act and licensed under the Maltese Banking Act by the M.F.S.A. These entities conduct business across the E.U. and the local legislation is compliant with E.U. directives, including the Markets in Financial Instruments Directives (“M.i.F.I.D.” and “M.i.F.I.D II”), 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 is actively promoting Malta as the “Blockchain Island.” With the hope of attracting companies involved in this sector to set up their offices in Malta, a number of legislative initiatives are underway, including the establishment of the Malta Digital Innovation Authority and the creation of a legal framework to regulate digital ledger technology and cryptocurrencies.

## TAXATION OF COMPANY PROFITS

Unless an exemption from tax or a special fiscal regime applies to a company as a result of industry-specific or license-specific tax incentives under Maltese law, companies registered in Malta are generally taxed at the flat rate of 35%.

However, the Income Tax Acts allow for certain types of income to be taxed separately at the source. Included are (i) bank interest, which may be taxed at the source at the rate of 15% upon an election to that effect by the taxpayer, and (ii) gains from a real property transfer, when performed as a one-off transaction and not by a company whose trade is real property speculation.

The tax is levied on the taxable income of a company earned in the fiscal year being assessed, after accounting for deductible expenses that are wholly and exclusively incurred in the production of the income. Losses from prior years may be carried forward to offset the profits of the current year. Capital losses may not offset operating profits. Such losses may be used only to offset capital gains.

Malta applies the full imputation system of taxation, meaning that tax paid by a company is allowed as a credit when dividends are received by its shareholders.

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Accountable Manager), Chief Technology Officer, Chief Commercial Officer, Portfolio Manager, Chief Investment Officer, Senior Trader/Trader, Senior Analyst (including Structuring Professional), Actuarial Professional, Chief Underwriting Officer, Chief Insurance Technical Officer, Odds Compiler Specialist, Head of Research and Development (including Search Engine Optimization and Systems Architecture), Aviation Continuing Airworthiness Manager, Aviation Flight Operations Manager, Aviation Training Manager, and Aviation Ground Operations Manager, Head of Marketing (including Head of Distribution Channels), or Head of Investor Relations; and employment with undertakings holding an aerodrome license issued by the competent authority, consisting of employment as Chief Executive Officer.

Upon written request, companies that are in compliance with their taxing obligations may be furnished with a Fiscal Residence Certificate issued by the Commissioner for Revenue, proving their fiscal good standing in accordance with Maltese law.

## TAX ACCOUNTING

Profits generated by a company are allocated to the final taxed account, foreign income account, immovable property account, the Maltese taxed account, or the untaxed account, depending on the revenue streams flowing into the company. The allocation of profits to these accounts is relevant when considering the distributions made by the company and, in particular, when a shareholder who has received a dividend files an application for a tax refund. Distributions are to be made in the following order of priority: (i) profits allocated to the final tax account, (ii) profits allocated to the immovable property account, (iii) distributions from the foreign income account, and (iv) profits allocated to the Maltese taxed account.

The allocation of profits is classified as follows:

- **Final Taxed Account.** The profits allocated to this account consist of income that, in accordance with the provisions of the Income Tax Acts, is subject to a final withholding tax or upon which no further tax is payable. The full imputation system does not apply to the final taxed account. Distributions from the final taxed account are not subject to further tax.
- **Immovable Property Account.** The profits allocated to the immovable property account consist of income that is derived from immovable (real) property situated in Malta. Such profits include, *inter alia*, gains on the sale of property, rents, interest on loans to finance the acquisition of property situated in Malta, income from hotel accommodations, insurance premiums related to property situated in Malta, and any other income which is connected to Maltese immovable property. It also includes a notional allocation in those instances where the property is owned by a company and is used for the purposes of its business activities (notional rent).
- **Foreign Income Account.** The profits allocated to this account consist of income from sources outside Malta and include, *inter alia*, royalties, dividends, capital gains, interest, rents, income derived from participating holdings, profits attributable to a permanent establishment outside of Malta, and income from investments held outside Malta.
- **Maltese Taxed Account.** The profits allocated to the Maltese taxed account have been subject to tax already, generally at the rate of 35%. It also includes profits on which a lower rate of tax has been applied.
- **Untaxed Account.** The allocation to this account represents the arithmetical difference between the total profits earned by the company and those that are allocated to the various other tax accounts. Distributions out of the untaxed account are subject to a 15% withholding tax if the recipient is a Maltese-resident individual. On the other hand, non-resident individuals and Maltese-resident companies fall outside the definition of “recipient” and, in the case of such distributions, withholding tax is not applicable.

“The Maltese government is actively promoting Malta as the ‘Blockchain Island.’”

## MALTESE REFUNDABLE TAX SYSTEM

The Maltese refundable tax system, as approved by the E.U., offers a significant advantage because when a company distributes its profits, all shareholders receiving the dividends are entitled to a refund of the tax paid by the company. Nonresident status is not a relevant factor in determining entitlement to the refund. The amount of the refund depends on the nature of the income and the manner in which the income has been allocated to the different tax accounts. The various types of refunds and the circumstances under which they apply are illustrated hereunder:

- **Six-Sevenths Refund.** The six-sevenths refund is applicable to distributions made from profits allocated to the Maltese taxed account or to the foreign income account where such income does not consist of passive income or royalties.
- **Five-Sevenths Refund.** The five-sevenths refund applies to distributions of profits derived from passive interest, royalties, and dividends received from participating holdings that do not meet the anti-abuse provisions.
- **Full Refund.** Shareholders may apply for a full refund of the Maltese tax paid by the company in those instances where a dividend has been paid from profits derived from income received in connection to a participating holding. When such income qualifies for the participation exemption, the company receiving the income may exclude it from the income tax computation. In this instance, such income will be allocated to the final tax account, and no further tax will arise on the distribution of income allocated to this account when paid to nonresidents of Malta.

Malta's tax system has been under attack in a series of articles published in the international press. The articles refer to data obtained from publicly available sources and leaked information. The data portrays Malta as an offshore tax haven due to its full imputation system of taxation.

The Maltese system of taxation has been the subject of lengthy and detailed discussions with the European Council and the Director-General for Competition regarding State Aid. It has also been discussed with the E.U. Member States within the Code of Conduct Group, consisting of representatives from the Finance Ministries and tax authorities of various Member States. The Code of Conduct Group identifies tax measures that are harmful under the Code of Conduct for business taxation. In the report submitted to the Economic and Financial Affairs Council ("E.C.O.F.I.N.") in November 2016, the Code of Conduct Group concluded that the Maltese tax system is not harmful. Malta was and has consistently been transparent about its tax system: it is aimed at creating an attractive system that provides comparable benefits to domestic and foreign investors.

In addition, the European Council has not brought any cases against Malta related to a violation of the "four freedoms" or the principle of nondiscrimination. Malta has fully implemented and complied with all of the E.U.'s tax directives, which are unanimously approved by the Member States in E.C.O.F.I.N, and the Maltese tax system has not been found to infringe on the E.U.'s State Aid rules.

Globally, Malta has applied all O.E.C.D. initiatives to combat tax evasion, including the directives on mutual assistance between tax authorities, automatic exchanges

of information, and the exchange of tax rulings and advance pricing arrangements in the field of transfer pricing. Malta is also an early adopter of the Common Reporting Standards and Country-by-Country Reporting obligations. Under Phase II of the O.E.C.D.'s Peer Reviews, Malta has been classified as “largely compliant” in matters of transparency and exchange of tax information. The United Kingdom, Germany, the Netherlands, and Italy received comparable clarification.

In June 2016, together with other Member States in E.C.O.F.I.N., Malta approved the Anti-Tax Avoidance Directive (“A.T.A.D.”). Throughout its presidency of the European Commission, all Member States gave approval for the A.T.A.D. 2 in February 2017.

In sum, the debate revolves around the morality of setting up companies in a low-tax E.U. jurisdiction. These issues have already been addressed in detail by the E.C.J. in the *Cadbury Schweppes* decision. The E.C.J. held that anti-avoidance provisions such as controlled foreign corporation (“C.F.C.”) provisions cannot hinder the fundamental freedom of establishment of the E.U., and that profits of a subsidiary in another Member State with a lower rate of taxation can only be taxed in the country of residence of the parent company if the subsidiary is wholly artificial.

*“When a company distributes its profits, all shareholders receiving the dividends are entitled to a refund of the tax paid by the company.”*

## 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>8</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

<sup>8</sup> For this purpose, the holding of shares by a Maltese-resident company in a company not resident in Malta that derives more than 50% of its income from portfolio investments is itself deemed to be a portfolio investment.

capital is wholly or partly divided into shares, and the shareholding confers an entitlement to at least 10% of any two of the following:

- Voting rights
- Profits available for distribution
- Assets available to shareholders upon liquidation
- A company is a shareholder in another company (the “target company”) and is entitled, at its option, to acquire the entire balance of the issued and outstanding shares in the other company.
- A company is a shareholder in the target company and holds a right of first refusal over all shares in the target company that are owned by others in the event of a proposed disposal, redemption, or cancellation.
- A company is a shareholder in the target company and is entitled to board participation.<sup>9</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.

## OTHER EXEMPTIONS

Other exemptions apply, the most important of which include the following:

- **Permanent Establishment.** Income or gains derived by a company resident in Malta are exempt from Maltese taxation if attributable to a permanent establishment situated outside of Malta. The exemption covers income from ongoing operations and gain from a sale of the assets of the permanent establishment. For purposes of the exemption, “profits or gains” shall be calculated as if the permanent establishment is an independent enterprise operating in similar conditions and at arm’s length.<sup>10</sup>
- **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.

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<sup>9</sup> To be considered a participation, the right to nominate members of the board of directors should be a majority right.

<sup>10</sup> If, in the opinion of the Commissioner, a series of transactions is effected with the main purpose of reducing the income tax liability of any person through the operation of the permanent establishment exemption, that a person is assessable as if the exemption did not apply. A series of transactions means two or more corresponding or circular transactions carried out by the same person, either directly or indirectly, as the case may be.

## WITHHOLDING TAXES ON DIVIDENDS DISTRIBUTED

No withholding taxes are levied on dividend distributions to a nonresident shareholder, provided that the shareholder is not directly or indirectly owned and controlled by, and does not act on behalf of, an individual who is ordinarily resident and domiciled in Malta.

## WITHHOLDING TAXES ON INTEREST PAID

No withholding taxes are levied on interest payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the interest is effectively connected therewith. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

## WITHHOLDING TAXES ON ROYALTIES PAID

No withholding taxes are levied on royalty payments made by a Maltese company to a nonresident, except in two circumstances. The first is when the nonresident is engaged in trade or business in Malta through a permanent establishment situated in Malta and the royalty payment is effectively connected with that permanent establishment. The second is when the nonresident is directly or indirectly owned and controlled by, or acts on behalf of, one or more individuals who are ordinarily resident and domiciled in Malta.

## TRANSFERS OF SHARES IN A MALTESE COMPANY

Malta imposes a stamp duty on transfers of shares in a Maltese company. However, an exemption applies to transfers of shares in a Maltese company in which (i) more than 50% of the ordinary share capital, voting rights, and rights to profits are held by persons not resident in Malta or by the trustee of a trust in which all beneficiaries are nonresident with regard to Malta, and (ii) ownership or control is not held, directly or indirectly, by persons resident in Malta. No capital gains tax is due on a transfer by nonresidents. The exemptions do not apply if the company owns immovable property in Malta.

Similar exemptions from stamp duty and income tax liability apply when the value of the ownership is shifted from one shareholder to another shareholder by way of the issuance of shares by the company. The value of the ownership is represented by the percentage share capital held or the voting rights held in the company. In terms of Maltese law, these are considered as deemed transfers.

## DOUBLE TAXATION RELIEF

With respect to the Income Tax Acts, relief from double taxation may take one of three forms: (i) treaty relief, (ii) unilateral relief, or (iii) flat rate foreign tax credit.

*“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.”*

## **Treaty Relief**

Treaty Relief is available if all the following criteria are satisfied:

- Under the relevant double tax treaty, the foreign tax paid in the other state is allowed as a credit against tax payable in Malta;
- The foreign tax is of a similar character to the tax imposed in Malta; and
- The person making the claim is a resident of Malta during the year immediately preceding the year of assessment, and tax is payable on such income.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Malta's double tax treaty network is made up of treaties in force with more than 70 states, listed below. These treaties are by and large modeled after the O.E.C.D. Model Convention provisions and treaty interpretations as per the Commentaries.

Albania	Andorra	Australia	Austria
Azerbaijan	Bahrain	Barbados	Belgium
Bulgaria	Canada	China	Croatia
Curaçao	Cyprus	Czech Republic	Denmark
Egypt	Estonia	Ethiopia	Finland
France	Georgia	Germany	Greece
Guernsey	Hong Kong	Hungary	Iceland
India	Ireland	Isle of Man	Israel
Italy	Jersey	Jordan	Kuwait
Latvia	Lebanon	Libya	Liechtenstein
Lithuania	Luxembourg	Malaysia	Mauritius
Mexico	Moldova	Montenegro	Morocco
Netherlands	Norway	Pakistan	Poland
Portugal	Qatar	Romania	Russia
San Marino	Saudi Arabia	Serbia	Singapore
Slovakia	Slovenia	South Africa	South Korea
Spain	Sweden	Switzerland	Syria
Tunisia	Turkey	Ukraine	United Arab Emirates
United Kingdom	United States	Uruguay	Vietnam

Treaties are currently in various stages of negotiation with Bosnia and Herzegovina, Oman, and Thailand. A protocol on the exchange of information with regards to the treaty in force between Malta and Belgium was signed on January 19, 2010, but as of this publication it is still pending ratification and entry into force.

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

## **Unilateral Relief**

In order to claim unilateral relief, the following conditions must be met:

- Treaty relief is not available to the person making the claim.
- The income in question arises outside of Malta and is subject to tax in the state of its source.
- The foreign tax is of a similar character to the tax imposed in Malta.
- The person entitled to the income is resident in Malta, or is a company registered in Malta for the year immediately preceding the year of assessment, and tax is payable on such income.
- The person making the claim proves to the satisfaction of the Commissioner of Inland Revenue that the foreign income has borne foreign tax and proves the amount of the tax.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

## **Flat Rate Foreign Tax Credit**

The Flat Rate Foreign Tax Credit is available if the following conditions are met:

- Treaty relief and unilateral relief are not available to the person making the claim.
- Income or gains are received by a company registered in Malta, which includes a Maltese branch of a nonresident company.
- The company is empowered to receive such income or gains.
- The income or gains are allocated to the foreign income account.
- Documentary evidence is made available that is satisfactory to the Commissioner for Revenue that the income or gains are to be allocated to the foreign income account.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

## **B.E.P.S. AND OTHER INITIATIVES**

Malta actively participates in initiatives against harmful tax competition, which includes cooperation in foreign tax-related matters. It was one of the first states to enter into an intergovernmental agreement with the United States to allow for the implementation of F.A.T.C.A.<sup>11</sup> Maltese implementation of the F.A.T.C.A. provisions

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<sup>11</sup> Malta and the U.S. signed a Model 1 I.G.A. on December 16, 2013.

*“Maltese transfer pricing rules are relatively flexible. Maltese income tax law contains no thin capitalization rules or C.F.C. rules.”*

was published on March 7, 2014.<sup>12</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. and was enacted in Maltese legislation on April 27, 2018.<sup>13</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 adopted into Maltese law effective July 22, 2011.

Malta is an early adopter of the Common Reporting Standard and is expected to submit its first report by the end of June 2017, focusing on the financial year ending on December 31, 2016.

Malta signed an Exchange of Information Agreement with Macau (signed on May 30, 2013, but not yet in force). Other agreements already in force include the Bahamas (January 15, 2013), Bermuda (November 5, 2012), the Cayman Islands (April 1, 2014), and Gibraltar (June 12, 2012).

In compliance with the E.U.’s Fourth Anti Money-Laundering Directive,<sup>14</sup> Malta has implemented the Ultimate Beneficial Ownership Register via the enactment of the Companies Act (Register of Beneficial Owners) Regulations.<sup>15</sup>

## CONCLUSIONS APPLICABLE TO MALTA

The legal framework in Malta offers several key advantages for those seeking to conduct international business in a sound and reputable jurisdiction.

Maltese transfer pricing rules are relatively flexible. Maltese income tax law contains no thin capitalization rules or C.F.C. rules, although specific legislation in regard to the latter will be enacted under directives issued by the European Commission. Several anti-abuse rules are contained in Article 51, designed to combat artificial

<sup>12</sup> See Exchange of Information (United States of America) (F.A.T.C.A.) Order, Legal Notice 78 of 2014.

<sup>13</sup> See Multilateral Convention (Implementing Tax Treaty Measures to Prevent Base Erosion and Profit Shifting) Order, Legal Notice 142 of 2018.

<sup>14</sup> See Directive (E.U.) 2015/849 of the European Parliament and of the European Council of May 20, 2015.

<sup>15</sup> See Legal Notice 374 of 2017. These regulations were enacted as part of wider legislation creating separate Ultimate Beneficial Ownership Registers for the purposes of the Trusts and Trustees Act (Legal Notice 373 of 2017) and the Civil Code with respect to foundations (Legal Notice 375 of 2017), all intended to ensure compliance with the provisions of the Fourth Anti-Money Laundering Directive.

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.



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We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

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## Contacts

If you have any questions regarding this publication, please contact the authors or one of the following members.

### **NEW YORK**

150 EAST 58<sup>TH</sup> STREET, 22<sup>ND</sup> FLOOR, NEW YORK, NY 10155

Galia Antebi	<a href="mailto:antebi@ruchelaw.com">antebi@ruchelaw.com</a>	+1 212.755.3333 x 113
Beate Erwin	<a href="mailto:erwin@ruchelaw.com">erwin@ruchelaw.com</a>	+1 212.755.3333 x 116
Fanny Karaman	<a href="mailto:karaman@ruchelaw.com">karaman@ruchelaw.com</a>	+1 212.755.3333 x 127
Nina Krauthamer	<a href="mailto:krauthamer@ruchelaw.com">krauthamer@ruchelaw.com</a>	+1 212.755.3333 x 118
Jennifer Lapper	<a href="mailto:lapper@ruchelaw.com">lapper@ruchelaw.com</a>	+1 212.755.3333 x 124
Andrew P. Mitchel	<a href="mailto:mitchel@ruchelaw.com">mitchel@ruchelaw.com</a>	+1 212.755.3333 x 122
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
Sheryl Shah	<a href="mailto:shah@ruchelaw.com">shah@ruchelaw.com</a>	+1 212.755.3333 x 112
Rusudan Shervashidze	<a href="mailto:shervashidze@ruchelaw.com">shervashidze@ruchelaw.com</a>	+1 212.755.3333 x 117
Francesca York	<a href="mailto:york@ruchelaw.com">york@ruchelaw.com</a>	+1 212.755.3333 x 125
Elizabeth V. Zanet	<a href="mailto:zanet@ruchelaw.com">zanet@ruchelaw.com</a>	+1 212.755.3333 x 123

### **TORONTO**

130 KING STREET WEST, SUITE 2300, TORONTO, ON M5X 1C8

Michael Peggs	<a href="mailto:peggs@ruchelaw.com">peggs@ruchelaw.com</a>	+1 212.755.3333 x 232
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## Editorial Staff

Jennifer Lapper	Managing Editor, Art Director
Francesca York	Graphics Editor
Brandon Shirazi	Copyeditor

PHOTOS IN THIS ISSUE WERE TAKEN BY:

Galia Antebi, Jennifer Lapper, Simon Prisk, Stanley C. Ruchelman, and Francesca York.